NEW RENTS ECONOMY – U.S. INEQUALITY IN THE 21ST CENTURY

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ABSTRACT: Rents in the U.S. economy now constitute a significant and growing fraction of national income. In effect, the post-industrial U.S. is becoming more like Saudi Arabia as these new rents arise in very concentrated form. Thus, policy is now obliged to focus more on distribution rather than the traditional emphasis on production and efficiency. The expanding impacts of trade and technology now combine with the increased production of 'knowledge goods' to sharply increase income inequality. The paper argues that the root cause of the inequality surge is the proliferation of new rents in sharp contrast to the Piketty’s focus on capital accumulation in a neoclassical context. Once rents exceed a certain threshold (share of national income), then it is no longer permissible to maintain the neoclassical presumption that it can be neglected. Then the policy implications are completely revered – even revolutionary – with regard to the stance on redistributions, higher education, incentives and capital taxation, etc.

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KEYWORDS: US rents economy; income distribution.

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A NOVA ECONOMIA DAS RENDAS: DESIGUALDADE NOS EUA NO SÉCULO XXI

RESUMO: Nos Estados Unidos da América, as rendas hoje constituem uma fração significante e crescente da renda nacional. De fato, os EUA pós-industrial estão ficando mais parecidos com a Arábia Saudita na medida em que essas novas formas de rendas surgem de forma mais concentrada. Em vista disso, as políticas se veem agora obrigadas a focar mais na distribuição ao invés de na produção e na eficiência, como se fazia tradicionalmente. O crescente impacto do comércio e da tecnologia agora se combina à produção cada vez maior de “bens baseados em conhecimento” para aumentar de forma vertiginosa a desigualdade de renda. Neste artigo, argumenta-se que a principal causa da desigualdade reside na proliferação de novas formas de rendas em forte contraste com o foco de Piketty na acumulação de capital no contexto neoclássico. Uma vez que as rendas ultrapassam determinado limite (dado pela participação na renda nacional), não se pode mais permitir a manutenção do pressuposto neoclássico que negligencia isso. Logo, as implicações de política são cruciais – até mesmo revolucionárias – no que diz respeito a redistribuição, educação superior, incentivos e taxação de capital.

PALAVRAS-CHAVE: economia das rendas nos EUA; distribuição de renda.
1. INTRODUCTION

In economies everywhere the issue of rents raises a range of concerns that center on income distribution and fairness as well as public efforts to ameliorate them. The advanced post-industrial countries, in particular, have seen a recent resurgence of interest in the study of income inequality: its level and trends, causes, and possible remedial policy measures. This paper will highlight noted structural changes over the past 25 years that reflect the emergence of a new rents economy that is intimately related to income inequality. The new trends are best understood as “the U.S. economy is becoming more like Saudi Arabia”, as an increasing portion of national income now derives from unearned rents.

This rent income – like manna from heaven – falls almost at random on a tiny part of the population due to luck or idiosyncratic talents that enjoy unexpected large gains due to changes in the economic/technological landscape. (The “new rents” in our terminology should be distinguished from the standard “rents” which include mostly unearned income from capital). The spurt in large new rents has contributed significantly to concentration at the top end of the income distribution. Accompanying structural trends in technology and trade also explain the decline of relative incomes across the middle and lower end of the income spectrum.

The major alternative explanation is due to Thomas Picketty (2013). His analysis of trends in income and wealth inequality for over a century in the U.S. and other developed countries points to capital accumulation rather than the new rents as the major explanatory factor. His argument (summarized in Section 2) indicates an inherent tendency in capitalism for the wealth to rise relative to national income. He claims this to be an empirical truth over the long term except for an exceptional interregnum over the 1929-1980 period. As the wealth to income ratio W/Y rises, income inequality also rises due to a rise in capital income. Piketty’s analysis has increased the acceptance of income distribution studies among neoclassical economists, but precludes other heterodox explanations. Unfortunately, the neoclassical paradigm serves as a procrustean bed for fitting in phenomena that actually arise in the new context wherein significant new rents most definitely are not of neoclassical origin.

Section 3 contrasts our new rents model with the Piketty model as it criticizes marginal productivity theory which is based on factor returns to capital and labor. This paper attributes the rising inequality to the expanding phenomenon of new rents over the recent decades. This section proceeds to draw out sharp contrasts that arise specifically in the areas of: empirics, theory, and policy.
2. THE NEW RENTS ECONOMY

In recent decades the US has seen a steady shift away from its traditional economic structure more towards an economy based on unearned rents that typifies countries such as Saudi Arabia that have received resource windfalls. Yet most analysts continue to use the outdated neoclassical production paradigm even as the underlying structure of the Unites States’ economy now takes on more aspects of a redistributive economy. Then matching changes in the political-economy have radical implications for diverse areas including social policy, fiscal policy, corporate governance, outsourcing, education, trade policy, etc. Based on their customary norms Westerners tend to be disdainful of the rents based Saudi Arabia’s political-economy. Yet if Westerners realized how similar they have become, their attitudes might become more sympathetic towards the imperatives of a redistributive economy.

Today, the US’s comparative advantage stems increasingly from producing one type of product (call it hi-tech), which has squeezed out much of traditional manufacturing production. This new sector typically involves a tiny number of people with very high productivity, so much of the rest of the nation’s labor force becomes increasingly superfluous, pushing its income lower. Exports of the high valued knowledge goods allow bountiful imports of manufactures from low wage countries. (Typically the US has a large persistent goods trade deficit – $225 billion in 2013). Thus arises the paradox of plentiful goods coexisting with chronically high unemployment. The key policy problem, just like in Saudi Arabia, then becomes not production but distribution – how best to engage the bulk of the population somehow in the economy, and how to spread incomes widely?

Historically, the neoclassical economics framework proved quite successful both in theory and policy. It also underpins an ethical system wherein the income distribution that stems from differences in productivity is deemed fair since the rewards match each factor’s marginal contribution to output. This familiar picture is upended over the past two decades by the significant structural changes summarized below:

1. Globalization and technological changes have led to deindustrialization.
2. Large expansion of the services sector mostly with low wages.
3. Expansion of “knowledge goods” production by a tiny number of workers.
4. Consequent sharp increase in income inequality due to very large rewards that look very much like unearned rents.

These prominent features are presented here as stylized facts that are so well known and accepted that establishing each may be superfluous. This section aims mainly to show how they are inter-related in our thesis. The first stylized fact is that in today’s global economy the U.S. is losing its comparative advantage in much of
manufacturing. This so called “Dutch disease” generally follows the discovery of windfalls from resources. For the Saudis, the prodigal flow of oil caused their exchange rate to strengthen and thereby makes most other exports uncompetitive. America’s new windfall must be seen to come in a different form: production of hi-tech, or more broadly, “knowledge goods”. This new exports category allows the country to import ample low price manufactured goods. Despite stalled job creation and stagnating wages in manufacturing, the representative worker/consumer still becomes wealthier in real terms.

Second, a large segment of American incomes now derive increasingly from the low wage services sector. The national “average”, however, covers a wide income range: from the super rich to labor incomes, with further distinctions between manufacturing and service sector wages. Critically income inequality has increased dramatically in the past decades, and continues to widen. For example, the intuitive measure: the ratio of CEO/worker salary has soared over ten times to exceed 300 over the past 45 years. Also, the share of the top 1% of income earners has gone from 16% to 22% of total income over the past 20 years alone.

The third major structural transformation is the steady increase in services sector employment and output. In 2012 it had reached 78% of private sector GDP and accounted for 82% of private sector employees (U.S. ITC, 2014). The size, diversity, and growth of services are so large that this sector merits deeper analysis. Normally the share of services grows as national income rises both due to consumption (Engels curve) effects and production changes due to trade and technology. The expanded importance of the services sector may be better understood by decomposing price and quantity changes to reveal the hidden role of rent-spreading activities and make-work jobs. The traditional understanding of services makes them coincident with non-tradeables such as taxi rides and hair cuts. The quantities of such items produced and consumed are not likely to have increased significantly. Instead, rapidly expanding segments known for generating rents now figure prominently; e.g. financial services, health and public sector – notably financial services’ share in the economy has doubled to 16% in one generation. (A measurement issue may account for some of the expansion since services formerly located within an industrial enterprise – e.g. accounting and payroll – are now outsourced to services firms and counted apart from industrial output.)

A neoclassical production function analysis is less applicable to the diverse services sector than to the industrial context of a century ago. Rent economics may provide a better alternative explanation for its expansion. To analyze this sector – some small expansion of output of traditional services is possible, but a hidden component may just be to create jobs and spread incomes. A final small segment of expanded service
sector employment is indeed due to expanded new production: of knowledge goods in the “new economy” that includes software, entertainment and support activities in the new global economy.

The inter-related structural changes summarized above are widely known as cliches. Less appreciated are the changes in the underlying theoretical paradigm that have revolutionary implications. First it is argued many of the lost manufacturing jobs are gone forever, never to be replaced. Further, since much of knowledge production is done by a very tiny set of people, in the economy of the future a vast portion of population will not be working; indeed, will not need to work! In this way U.S. begins to look even more like Saudi Arabia.

The above presentation is a thumbnail sketch of the recent structural changes in the U.S. economy. Note, however, that the paper is not mainly about these changes which are known and well established. While the economic structure has changed continuously there is no structural shift as such, so no specific dating can be established. The increased inequality in itself is used as a proxy for rents that are hard to isolate and measure. The main point of this paper is that beyond a certain threshold rents can no longer be assumed negligible and standard neoclassical theory and policy can no longer serve as before.

It must be admitted that the neoclassical framework has so far withstood many successive challenges. Luddite alarms of rising secular unemployment were repeatedly proved wrong. Job losses in particular sectors due to new technology or cheaper imports, prompted the creation of new industries and increased prosperity. One might ask: is today’s trade with China very different from the changes wrought by NAFTA a generation ago? Neoclassical economists retain their faith that free markets will adjust wages, absorb the redundant labor, and induce moves to more productive occupations. Such policies spawned familiar battles between the neoclassicals and their detractors. Historically, the Left feared zero sum games and urged income redistributions, while the neoclassicals countered with the positive gains flowing from free trade and markets. In sharp contrast, the current situation calls for an acceptance of both: our analysis affirms the benefits of technological change and trade and yet redistributions must be seen to have become an imperative.

The crucial new element is that modern knowledge production depends on the talents and efforts of a very small number of individuals or teams. Neoclassical economics tries to absorb this into the neoclassical framework by conflating innate talents with human capital. Unlike sparsely distributed God-given gifts, human capital can certainly be expanded on a large scale by universities. But this idea involves some amount of self-delusion: how much of the new knowledge economy is based on skills acquired through education and how much derives from natural talents and enterprise? Surely some minimum level of human capital matters as inspiration comes to the
prepared mind. Yet it’s implausible that the new economy will serve up tens of millions of new jobs for so many fresh university graduates. In its stead there are many examples of hugely productive IT inventions created by gifted individual undergraduates or tiny teams. While large teams of engineers systematically toil to seek out the next “killer app”, it seems inescapable that very valuable contributions often sprang randomly from the insights and enterprise of a handful of individuals. The crucial anti-neoclassical feature of such innovation and knowledge production is that it has negligible opportunity cost.

Once production no longer derives from the sacrifices of labor, the very ethical basis of economic society is upended. It mocks any merit gained from old fashioned hard-work or even education. Like the wage earner of mid century who gained his self worth by his daily toil, today’s CEOs with giant salaries continue to invoke those old saws. They pose as just as worthy, arguing that these huge salaries reflect their personal contribution to their firms’ value. Clearly these are rents, and it is largely luck that brought them these gains. At the other end of the political spectrum, those who are critical of corporate greed also miss the key point: that in today’s economy rents are everywhere, there for the taking. If I don’t take it someone else will!

Much value created in the New Rents Economy does not spring from the effort or sacrifice of any specific person. It then becomes hard to ascribe ownership of such rents except in a most legalistic way – be it winner take all or first past the post in a race. The issue of what constitutes a “fair” return is now redefined as what one can grab in a legalistic game, no matter how tortured the legalese or how large the prize. If corporate boards approve the compensation, then it is difficult to identify the precise crime even if $1m more to a CEO means $1m less to other stakeholders. In Saudi Arabia too, the income distribution is considered legal under their prevailing law. The ruling sheiks “own” the oil, so they can essentially distribute the proceeds to whomever they want.

In the U.S., a significant and growing fraction of national income now derives from the new rents. To roughly quantify its share of the economy – is it 5% or 15%? – the measured growth in inequality may itself serve as a proxy for the growing rents. While unearned incomes have always existed, neoclassical economists assumed implicitly that these were relatively insignificant and transitory. Rents deriving from creative talents such as copyrights and patents were approved, while improperly obtained monopoly rents were deplored.

The expanding new rents are viewed differently as evaluated from different vantages:

(i) The working classes deplore how the new economy has shorn its members of the basis of their self worth. Yet seeking protectionism would be like asking Saudi Arabia to stop exporting oil, its comparative advantage, and instead promote manufacturing or even farming!
(ii) The U.S.’s high earners stick to the self-justifying stance that their earnings reward their contribution despite these being mainly rents. Supporting them, conservatives oppose taxes supposedly to offer incentives for “work”. Yet the creative urge – as distinct from unpleasant hard work – will surely not be dampened if the tax rate rose somewhat.

(iii) The neoclassical economics focus on productivity is a relic from the industrial era in which the neoclassical production model applied most directly. But in any event, who can oppose growth of aggregate productivity? More is surely preferred to less, but today’s output growth comes increasingly from inventions like Google, or even marketing innovations, in which large rewards flow to a tiny group. While the U.S. as a whole becomes richer, the redistributive burden becomes ever harder. In the few industrial sectors that still remain competitive ongoing efforts to raise productivity are laudable, yet hoping to overcome the low wage advantage of poor countries will remain an uphill task.

(iv) Rapidly expanding services employment presents something of a puzzle: admittedly, all free market exchanges are Pareto improving, but can everyone get rich by taking in each others’ laundry? Of all the various segments of expanded services, it is mainly the production of “idea goods” that unambiguously add to GDP.

(v) A separate key “contribution” of the services sector is that much of its expanded employment provides a rent spreading function that is becoming increasingly necessary. Saudi Arabia’s large public sector expressly serves the socially useful function of spreading rents among its citizens. But further expanding public redistribution efforts would be difficult from already strained public budgets. Unlike Saudi Arabia whose rents flow directly to the public exchequer, in the U.S. the added rents go first to private individuals; thus a separate step, taxation, is necessary in the redistribution process.

Given the increasing income concentration in the new economy, policy must focus on how to spread this bounty widely. Redistributions no longer go only to those unable or unwilling to work. Many have not become poor because of their lack of effort. On the contrary, it is becoming rational for society to encourage much of labor to sit out and do nothing. Make-work jobs are more palatable as they also provide worthwhile psychic benefits. The motive force of greed still operates, though less for increasing output and more as rent spreaders strive to grab a larger share of rents for themselves. “Rent spreading” as a socially desirable necessity in the New Rents economy must be distinguished from “rent seeking” which is viewed as a corrupt dysfunctional activity within the neoclassical framework.

Rent spreading can rely not just on familiar public sector or charitable institutions, but private sector efforts as well. Today’s self help efforts are enterprising service activities that aim to shear off some of the (excess) money from the rich elite. Expanding
occupations include marketers, agents, lawyers, celebrity chefs, parking valets, wine makers, etc. The paradox is that in the new economy Americans seem to be working harder, not less – grasping a larger share of rents can be just as hard as production work!

The higher educational sector largely serves a similar rent spreading purpose: much of it offers private gains from activities whose social contribution is near zero. Examples are the expanded marketing and liberal arts programs as compared to truly socially productive occupations in engineering and science. Yet the latter are increasingly ignored by Americans while foreigners fill these graduate programs. In the Saudi Arabia scene too productive activity is left to foreign “worker bees” while most Saudi Arabians rationally choose to congregate near the sources of more lucrative rents open only to the native born.

Here the Saudi example serves only as a dramatic analogy. Certainly there are significant differences: in the U.S. case, the large rents fall on a tiny lucky set in an almost random way, as opposed to the unchanging tiny privileged group in Saudi Arabia. The list of U.S. rent recipients is continuously turning over which acts to spread the concentrated rents. But after the initial creation, for the generation of heirs such fortunes grow only from investment returns. By contrast, the Saudi capital accumulation process includes continual flows of fresh rents to existing wealth holder in addition to natural capital growth. The applicable economic incentives therefore also differ in the two countries.

3. SUMMARY OF THE PIKETTY ANALYSIS

The major alternative view of the structural evolution of the U.S. economy is Piketty’s recent work. This section summarizes the relevant parts of his work in its three components: empirical, theoretical, and policy. The empirical work (WITH SAEZ and TUCMAN et al.) constitutes a major advance in inequality studies with several new elements: i) the very long term trends and cross country evidence, ii) measuring both wealth and income inequality, and iii) a focus on the very top end of the income distribution (.1% or .01%). Aside from this useful analysis of past data, Piketty offers a controversial theoretical model that is utilized for making future predictions.

Starting from the basic national income identity:

\[ Y = rK + wL \] (1)

In (1), the capital and labor shares of income are \( rK/Y \) and \( wL/Y \) respectively. Piketty points particularly to \( \beta \), the \( K/Y \) ratio, which evolves over time as \( Y \) grows at rate \( g \).
while capital grows at the capital accumulation rate, $r$. If $r > g$, the $\beta$ ratio will grow, and vice versa. Piketty argues that in the coming decades both $g$ and $r$ are likely to fall but $r$ will fall more slowly, leading to a rising $\beta$. Note that $r$ equals the gross rate of return on capital less depreciation needed for capital replacement – as well as other kinds of capital dissipation due to taxes, excess consumption, charity and capital destruction.

The share of capital income is simply the product $r \times \beta$. As the capital intensity $\beta$ rises in the economy, $r$ must decline due to diminishing marginal product of capital; but how fast does $r$ fall relative to the rise of $\beta$? This depends critically on the elasticity of factor substitution $\lambda$. As the price of capital falls how much more capital will producers use? Critics argue that Piketty’s assumed value is too high. Rognlie faults his analysis since it uses capital values rather than physical capital, which is needed for a correct interpretation. If the high $\lambda$ parameter becomes indefensible then Piketty’s explanation fails and other more plausible explanations must be sought for the observed rise in inequality.

Next, we move from this functional distribution to the personal distribution of income. Note that the wealth distribution is typically concentrated to begin with. And since the wealthy tend to have a larger savings propensity, their continued capital accumulation will further concentrate wealth. Piketty’s added assumption that $r$ falls slowly then ensures that the personal distribution of income will become ever more concentrated at the top end.

Obvious policy implications follow from this model based on capital accumulation by the wealthy. Piketty urges that the rich countries coordinate to apply an annual wealth tax in addition to a steeply progressive income tax. DeLong characterizes this as a “wedge” between social and net private returns that can work to limit capital accumulation. This could be enabled by political economy changes that rebalanced political power between capital and labor. An alternative policy would be to stiffen the estate tax that is set above a reasonably high wealth threshold. This would have smaller administrative / measurement issues than an annual wealth tax. Consider that a one-time 40% inheritance tax could do the work of a 1% annual wealth tax over a lifetime. Furthermore, incentives cannot be adversely affect the dead as they might for the living. A plausible argument could also be made for raising the lower preferential U.S. capital gains tax rate to bring it closer to the tax on labor incomes.

4. CONTRASTING THE TWO MODELS

The above sections presented a new rents explanation for growing income inequality versus Piketty’s focus on capital accumulation. This section will further contrast and critique the two views in terms of empirical data, theory, and policy implications. For
a valid comparison, note that my new rents model is based on only the past 20 years or so since the onset in a significant way of globalization and the knowledge economy. Piketty’s instead points to an upward trend in income inequality that has resumed since about 1980. Thus, any comparison of the two models may apply only for the recent decades, even though the upturn in the top end incomes is observationally equivalent for both models.

**Empirics:** Note first that summary measures (e.g. Gini coefficient) can reflect very different patterns of income distribution. Discussions about income distributions must instead focus on specific sections of the income range. Each has its own causal mechanisms leading to distinct policy implications. The rents model presented here relates to both worker incomes impacted by de-industrialization as well as top end incomes derived from rents, while Piketty focuses just on the latter. The detailed empirical measurements of income inequality can be especially helpful. Yet most policy discussions generally remain rather confused in this politically fraught area – mixing together the functional versus personal distribution of income, the blue collar/white collar distinction applicable in the middle range, poverty issues at the lower end, and the entirely different considerations that apply at the top .1% of the income distribution.

Piketty’s interpretation of the empirical data is also criticized by Rognlie (2014). His decomposition of broadly rising wealth measures show a major role for rising housing values and capitalized pensions. However, only inheritable pension accounts must be relevant for Piketty’s dynastic thesis. The valuation of housing is quite problematic aside from its large cyclic fluctuations: i) housing constitutes a significant fraction of total wealth only for the lower 99%, not for the upper 1% which is the focus of capital accumulation. ii) Values increase more due to price than quantity; that too mainly reflects changes in land prices. Rognlie points out that price changes for the housing component of capital account for virtually all of the W/Y increase in Piketty’s data. The rise in this ratio over the long term may be attributed entirely to the U.S. going from land surplus to land scarce especially along the West Coast and Manhattan – completely counter to Piketty’s capital accumulation story.

This paper offers another distinct criticism of Piketty’s analysis: that unearned rents are improperly counted as his data is based on tax returns. While the U.S. tax returns distinguish incomes by source such as wages, interest, dividends, etc. they do not separate out non-capital related rents – with some minor negligible exceptions. Then, by definition, virtually all income items are forced into the Procrustean bed of capital and labor returns. Consider this example: after the Google IPO, the founders’ vast new windfall would undoubtedly be classified as capital gain. Of course, any anticipated rents must be capitalized ex post, but it is a serious error to define these as
a ‘return to capital’ if they have *nothing to do with capital ex ante*. (To confound the empirical issue, sharp tax lawyers strive to reclassify income into any category that minimizes taxes; and long term capital gains do enjoy a lower tax rate.) In an analogous way, returns for idiosyncratic skills to sportsmen or entertainers are erroneously classified as labor income.

Piketty’s prediction of a rising capital share is based on $r$ remaining high. But his assumption that it will remain 4%, appears too high particularly as $r$ is the *net* real rate of return after depreciation and taxes. The current nominal risk-free nominal rate is well below 3%. Consider also the predictions of a global savings glut despite the emerging economies’ large investment programs. Even after central banks cut back global liquidity, the real rate is unlikely to rise over 2.5%. Thus the $r - g$ gap, if positive at all, may remain small. In that event Piketty’s prediction of a rising $W/Y$ would stretch over centuries rather than decades.

**Theory:** The theoretical contrast between Piketty’s neoclassical model and the rents model is seen clearly and simply in the added term to the income function:

$$Y = rK + wL + Rent$$

The added rents term could be a significant fraction of national income (say around 5-10%), and growing. In production function (growth) form the extra term is generally identified as the contribution of total factor productivity (TFP), but without specifying whether it goes to labor or employers. Neoclassical models tend to squeeze this separate conceptual contribution into the two standard categories of income – or three if human capital is split out as a third productive factor. For example, even astronomical 8-figure CEO salaries are categorized as marginal product of labor! It is equally bizarre to classify this as some kind of capital income. But why not call a spade a spade and simply call it a rent? Marxian analysis highlights this aspect by emphasizing how this rent is apportioned among capital and labor depending on prevailing power in a political struggle. The rents share of income does not come from any closed form solution and has not been properly quantified. Nonetheless, rents exist and must be dealt with.

Once rents are admitted as a serious empirical and theoretical possibility, Piketty’s purported spurt of capital income disappears. Nevertheless, income and wealth inequality can both keep trending upward due to new rents continuing, or even increasing, in a knowledge economy.

**Policies:** Policy arguments about dealing with income inequality follow the usual equity-versus-efficiency logic: any benefits of redistribution must be balanced against potential adverse incentive effects. But earnings from rents are largely immune from
adverse incentives. The urge to seek out the Next Big Thing is unlikely to diminish if the reward is “only” $.5 billion, not $5 billion. Yet most empirical studies of incentive effects are dated neoclassical studies of labor market responses or location decisions of firms. Thus the usual neoclassical claims of harming “job creators” appear to be based more on prior axiomatic beliefs rather than evidence.

Rewards in the knowledge economy are mostly based on first-past-the-post due to patents – or first-mover advantage in the case of network externalities. Ranking first often results purely from chance, yet the rewards can differ by as much as a factor of 1000 over the second place winner. In this scenario the incentives favor a large number of entrants in the race based on entrepreneurs’ probability calculations and risk preferences. No particular individual is justified in claiming special merit to deserve that huge prize – any other one of the participants in the race could have done it. Nevertheless, social benefits do accrue from more widespread participation in the race for innovation.

Apart from entrepreneurial windfalls, big rents also appear prominently in the form of huge CEO salaries. Many ad hoc explanations are offered for this phenomenon. One common explanation is that boards of directors and top executives all come from a clubby pool that supports each other. But this argument is hardly general enough – are principal-agent problems so dominant that profit maximizing firms will voluntarily sacrifice such a substantial part of their earnings? A plausible alternative explanation might follow these lines:

i) potential stakes are very high and proportional to firm size;
ii) few guidelines exist on how to pick managers who will make good judgment calls especially when “past record is no indicator of future success”; and
iii) boards then convince themselves that only a tiny set of candidates can do the job. Thus the high salary offered can be seen as a blind gamble based on hope. Such behaviors are typical syndromes of bounded rationality and behavioral economics, not neoclassical economics.

Trying to improve the income distribution, especially at the upper end, may be more effective using ex ante policy methods. Changes to patent law (now widely criticized for hindering rather than aiding innovation) and intellectual property rights rules could impact the large rents generated in the knowledge sectors such as IT and pharmaceuticals. In the financial sector regulatory reforms may also limit large unearned rents in the first place. Still, syndromes of behavioral economics remain hard to remedy; anyway consumer sovereignty dominates – for example, even sophisticated financial players voluntarily give huge rewards (say around 2% of trillions of dollars) to hedge fund managers even in the face of demonstrated sub-par returns. Such fads are no different in the arena of sports, fashion, or entertainment (even the Kardashians have hundreds of millions thrown at them!).
5. CONCLUSION

The New Rents economy differs from standard economic structure where neoclassical precepts apply. This distinction is seen most clearly in the policy prescriptions for the New Rents Economy as summarized below. These policies fall into broad categories corresponding to our rents model that have been detailed above. Prescriptions 1 and 2 point to the future imperative of redistributions both public and private. Prescriptions 3, 4 and 5 list the do’s and don’ts to address the expanding rents that have fueled income inequality. The last two are suggested reforms in tax policy. Such dramatically different, if not revolutionary, policy implications highlight how fundamentally different the New Rents model is from the standard neoclassical model.

1. The post-industrial New Economy creates permanent unemployment (along with slow wage growth) that will necessitate permanently expanded redistributions.
2. Public redistributions can be aided by self-help methods of rent spreading – which must be distinguished from ‘rent seeking’ considered a fault in the neoclassical framework.
3. Large rents stemming from the creation of knowledge goods do exacerbate income inequality. Yet discouraging such activities or returning to traditional manufacturing by resorting to protectionism is not a desirable remedy.
4. A favored neoclassical nostrum – an over reliance on human capital as a remedy – will likely not work since much of higher education serves mainly for rent spreading rather than expanding output.
5. Reforming patent and intellectual property laws as well as financial sector regulations can limit rents in the first place.
6. Disincentive effects of taxes apply less to creative efforts, especially for exceptionally large rewards flowing to innovations. Hence higher tax rates on such incomes may not hinder growth.
7. Instead of wealth taxes, a politically more plausible policy is raised inheritance taxes. Global tax coordination will still be imperative.

6. REFERENCES


