Brown Paper Bag Seminar

The return of rent:
Keynes answering Piketty on the puzzles of 21st century capitalism

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IS CAPITALISM EGALITARIAN IN THE LONG RUN?

KEYNES:

- A hundred years forward from 1930, labour will be scarce and valuable, and
- capital will be abundant and cheap
- euthanasia of the rentier

PICKETTY:

- Real rates of return stuck at 5% as through history
- r>g means increasing inequality (based on all income being returns to capital or labour and capital ownership concentrated)
- Capital accumulation means higher capital share and higher inequality
- Post World War II exception to be followed by return to gilded age inequality

KEYNES: RETURNS ON ALL INVESTMENT CONVERGE ON DECLINING INTEREST RATE:

"…the demand for capital is strictly limited in the sense that it would not be difficult to increase the stock of capital up to a point where marginal efficiency (of capital) had fallen to a very low figure. This would not mean that the use of capital instruments would cost almost nothing, but only that the return for them would have to cover little more than their exhaustion by wastage and obsolescence together with some margin to cover risk and exercise of skill and judgement."

- Tendency for owners of capital to save expands capital stock and interacts with declining marginal efficiency to produce low returns in the long run
- This paper refers to long term rates determined by markets not short term rates determined by policy
- Quantitative easing after GFC influenced without determining long term rates

PICKETTY: PERSISTENT AND INCREASING INEQUALITY

“With a savings rate of 8% (roughly that of the American economy) and GDP growth of 2%, wealth should rise to to 400% of annual output, for example, while a drop in long-run growth to 1% would push up expected wealth to 800% of GDP”

With average return of 5%

- if capital share equals 400% of GDP, its return is equal to 20% of GDP
- If capital stock is 800% of GDP, its return equals 40% of GDP
- concentration of wealth implies greater inequality with higher capital output ratio

NEO-CLASSICAL FRAMEWORK BUT NOT NEO-CLASSICAL PRESUMPTIONS SUPPORT KEYNES:

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- Swan-Solow has returns to capital falling and wages rising with capital accumulation
- Neo-classical economics presumes high interest rate floor from human time preference (Samuelson, 1937)
- Samuelson doubted empirical basis for inherent time preference
- But substantial time preference now written into economics literature
- Precautionary, Duesenberry, Weberian theories of savings remove floor.

REASONS WHY ZERO INTEREST MIGHT BE A LONG TERM FLOOR

- Keynesian liquidity preference removes persistent negative interest rates

- Interest rate floor also from infinite range of profitable investments at zero real interest:

"At a negative (or even zero) interest rate it would pay to level the Rocky Mountains to save even the small amount of fuel expended by trains and cars that currently must climb steep grades" (Bernanke paraphrasing Samuelson).

NEO-CLASSICAL SYSTEM HAS RISING LIVING STANDARDS FROM PRODUCTIVITY GROWTH

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- Raises returns to labour and delays fall to floor of interest rates
- Capital and labour affected differentially by biases in technological change
- Per capita growth rates converge on low levels determined by exogenous technological change

CHART 1.
G7 GROWTH RATES DECLINING OVER TIME

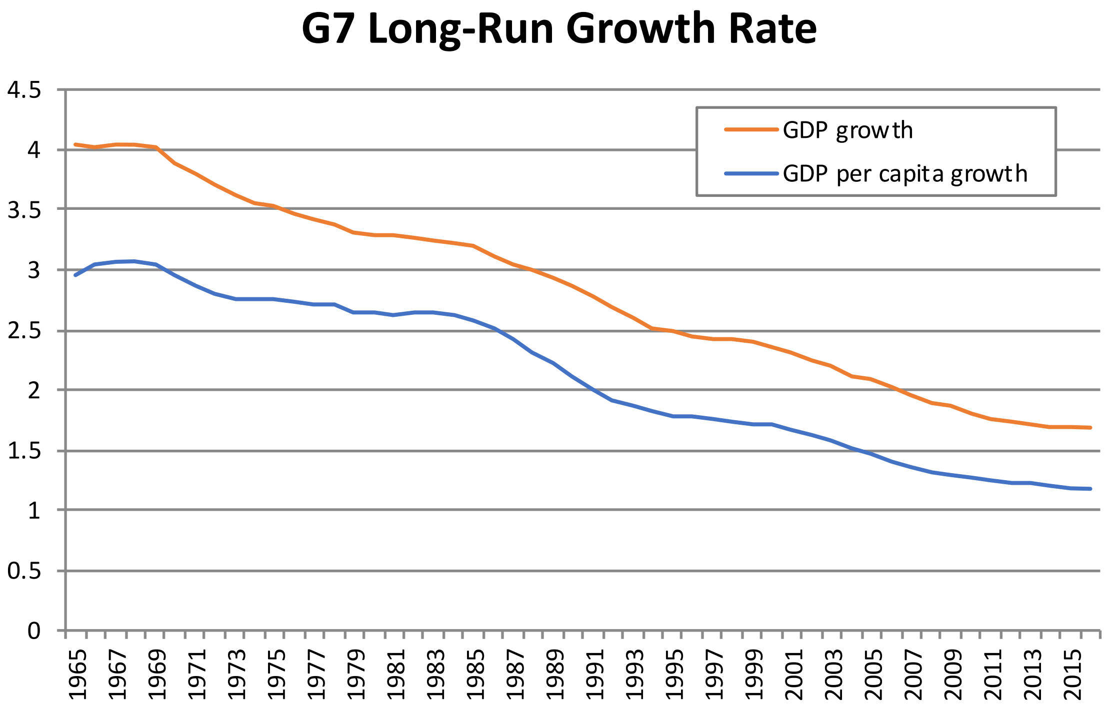
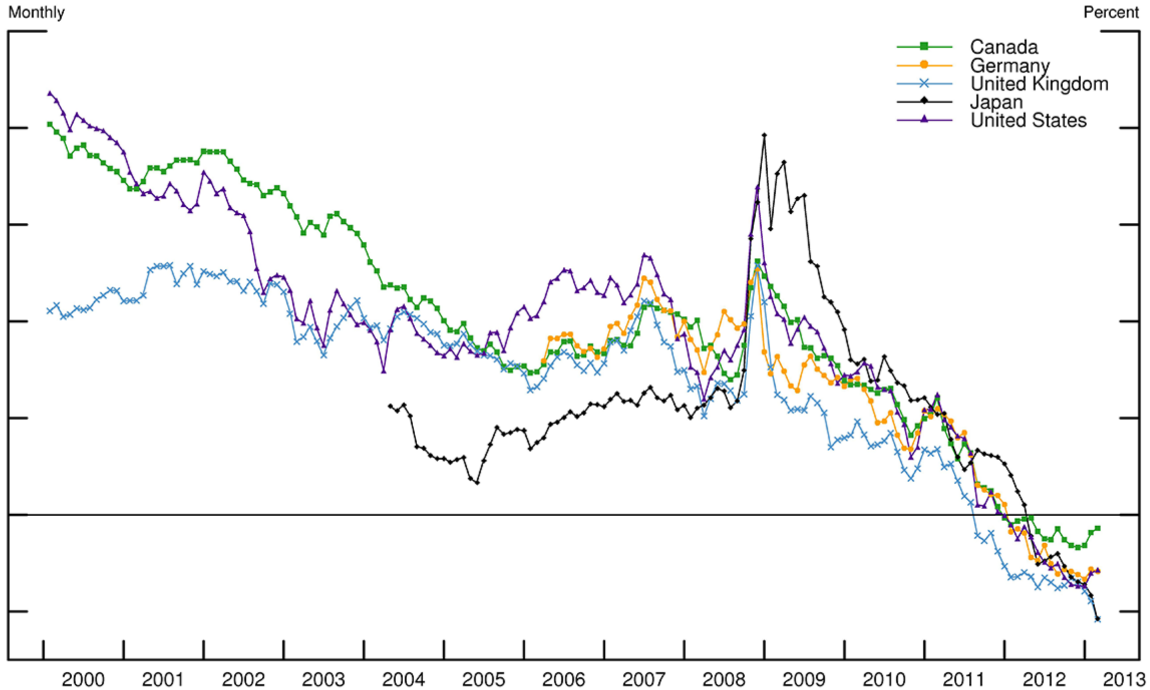


Chart 1. *Dynamic factor model of G7 long-run average growth rate with adjustments for stochastic volatility of business cycles, with data drawn from the model developed by Antolin-Diaz, Drechsel & Petrella (2017). Adjusted by the author for population growth from the World Bank to determine GDP per capita*

SUPPORTING KEYNES:
CHART 2.
AVERAGE REAL INTEREST RATES: returns on indexed bonds



Note: Par yields. The maturity for the U.S., U.K., and German bonds is 10 years. The current maturity for the Japanese bond is 5 years, and that for the Canadian bond is 8 years.
Source: Bloomberg.

Chart 2. Bernanke, 2013
https://www.federalreserve.gov/newsevents/speech/bernanke20130301a.htm

REASONS FOR DECLINING REAL INTEREST RATES: DECLINE IN INVESTMENT RATES:

- Lower population, productivity, output growth (reinforced by Keynesian investment accelerator going into reverse)
- Faster growth of sectors with lower capital-output ratios (services, IT consumption)
- Capital-saving technological change (application of IT)
- Higher proportion of output in rent-intensive sectors with constrained investment

REASONS FOR DECLINING REAL INTEREST RATES: RISE IN SAVINGS RATES:

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- High savings economies increasing their shares; Duesenberry effect and other sources of high savings rates in high growth economies like China
- Greater inequality in developed countries
- Population ageing
- Countries with weak social security increasing their shares (China, other developing countries)
- Weakening of welfare state in high income countries
- (Temporarily?) Fiscal tightening after GFC (temporarily reversed by Trump in US)

CHART 3.
SHIFTS IN SAVINGS AND INVESTMENT SCHEDULES SINCE THE 1980S.

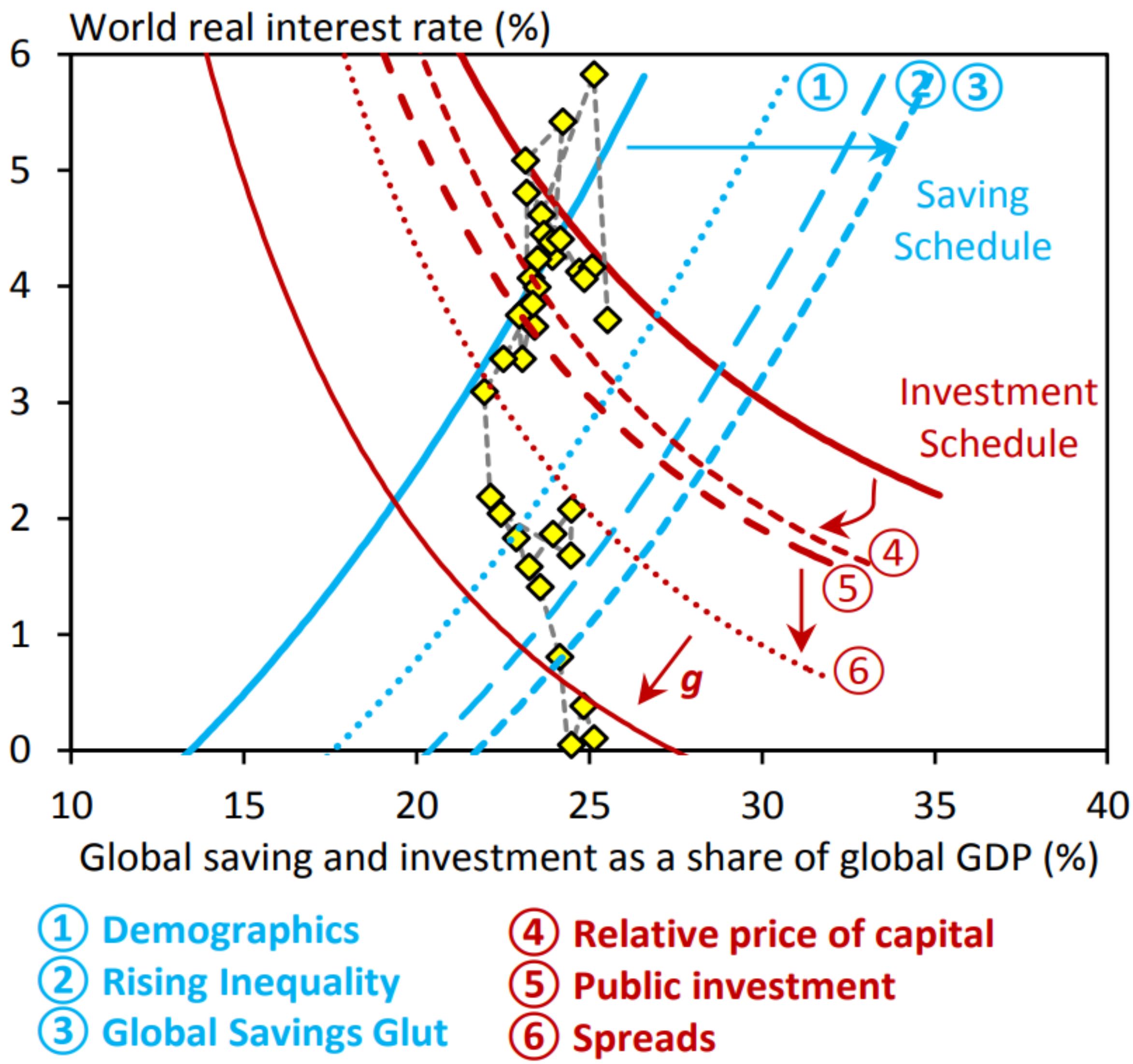

Chart 3.. Shifts in savings and investment schedules since the 1980s. Sourced from Rachel & Smith, 2015.

SOME EMPIRICAL REALITIES SUPPORT PICKETTY

- High and rising profit ratios and returns on investment
- Declining rates of growth
- High and rising wealth to income ratios
- Falling labour shares and rising capital shares
- Rising income and wealth inequality

BUT

- much rise in inequality the top 1% of labour incomes (top executives using management monopoly to claim business rents)
- rise in capital share much about increasing values in housing sector
- rise in wealth greater than in capital stock (capital gains in former)
- Picketty's use of gross not net investment and income affects numbers

CHART 4
DECLINING US LABOUR SHARE OF INCOME

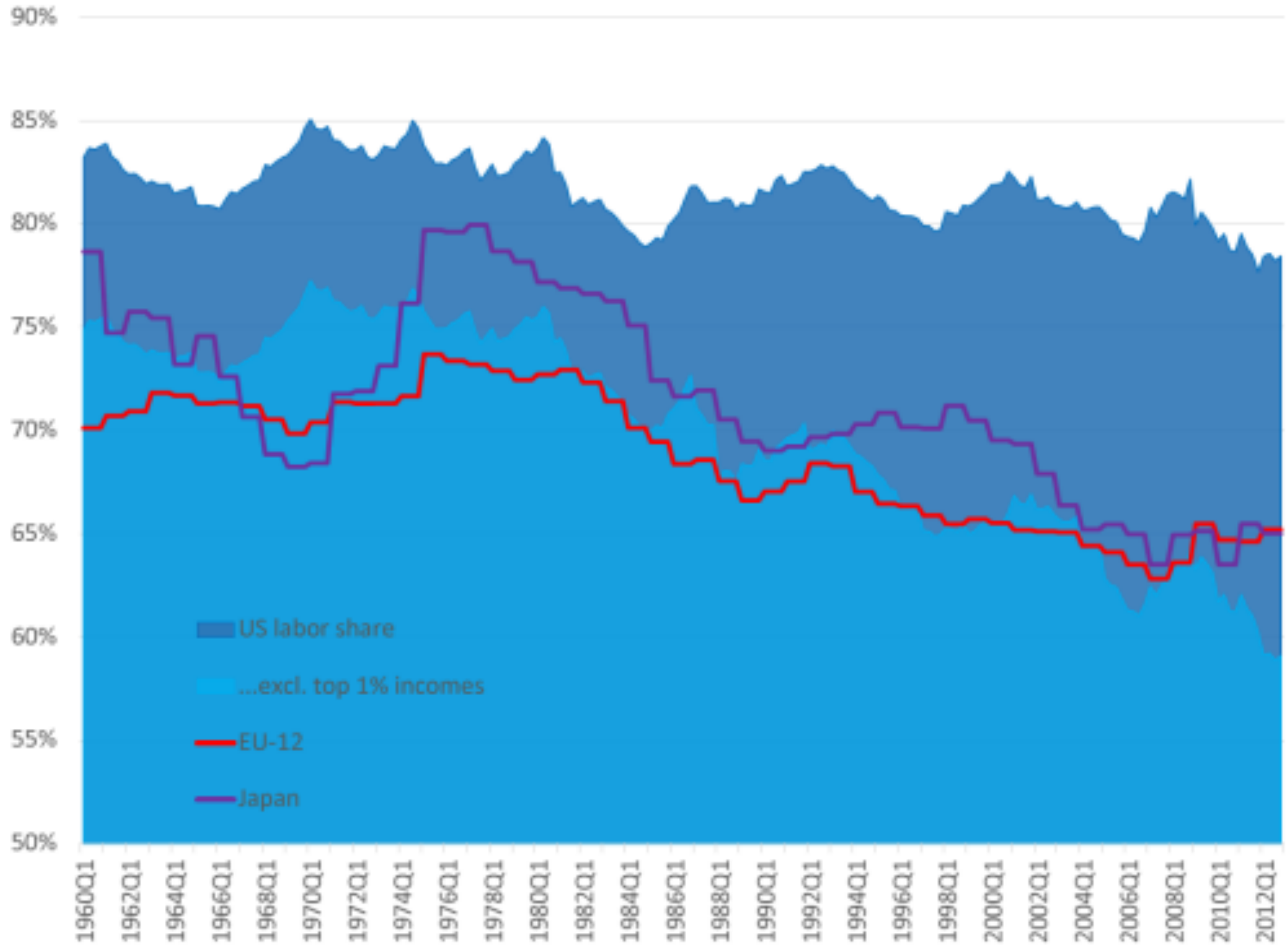

Chart 4: The US labour share, including and excluding top 1 percent labour incomes, and compared to EU-12 and Japan (Giovannoni, 2014).

CONUNDRUM: WHY RISING WEALTH RATIO AND RISING CAPITAL SHARE?
CHART 5.
RELATIONSHIP BETWEEN CAPITAL OUTPUT AND NET CAPITAL SHARE

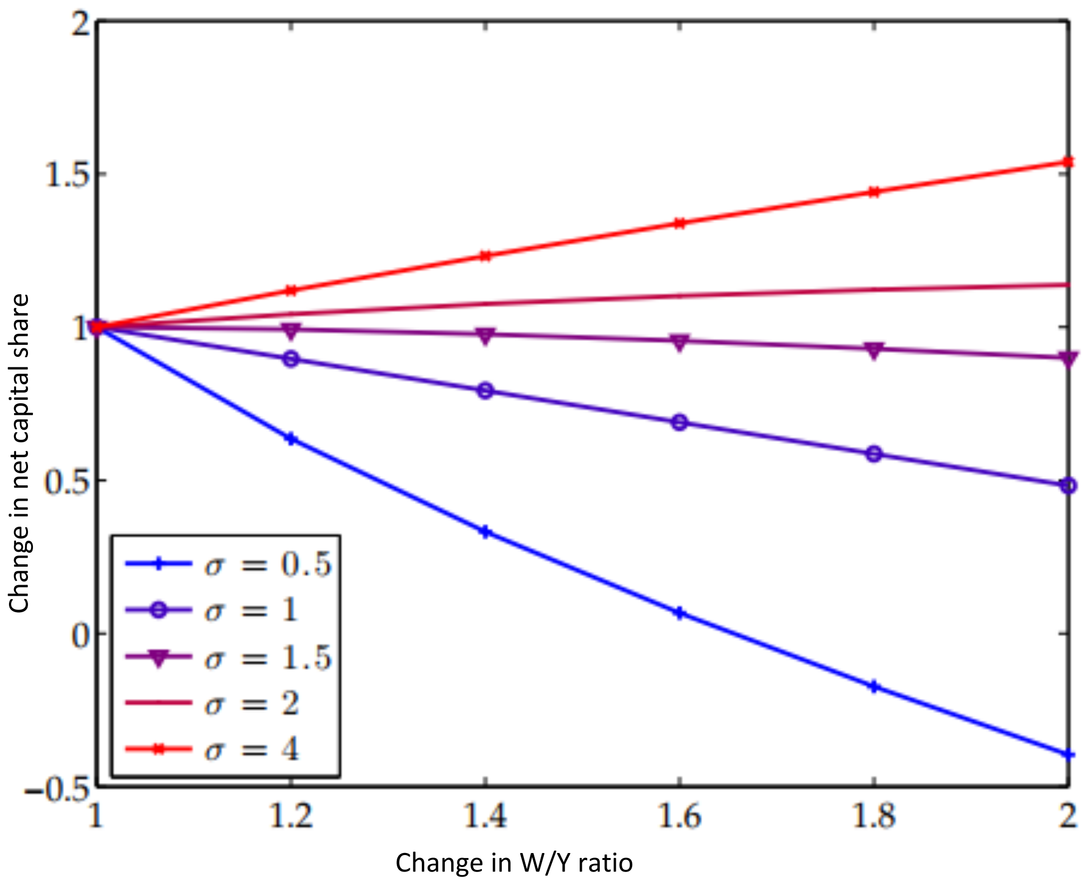

Chart 5: *Relationship between net capital-income ratio and net capital share, by gross elasticity σ (Rognlie, 2014). Note that empirical measures of gross elasticity a, are almost all below 1, hence increases in W/Y can be expected to decrease the capital share.*

RESOLVING THE CONUNDRUM: TWO SHORT TERM CAUSES OF SUPPORT FOR BOTH KEYNES AND PICKETTY

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- Returns to capital and inequality increased once-for-all by rising asset values from falling interest rates
- Low marginal efficiency of capital and interest rates in developed countries delayed by globalisation of economic activity

  - Need to examine effects of globalisation, but has not stopped decline in global real interest rates

LONG TERM RESOLUTION OF CONUNDRUM: COMPETITIVE v RENTIER CAPITALISM

COMPETITIVE CAPITALISM: Interest rates equal marginal return to capital equals average return in competitive parts of economy

RENTIER CAPITALISM: Marginal returns exceed interest rates in rent-intensive sectors

AVERAGE RETURNS therefore higher than marginal returns

AVERAGE RETURNS determine capital share of income

AVERAGE RETURNS can rise despite falling interest rates if rent-intensive sector growing in relative scale or absolute rate of return

THREE DETERMINANTS OF INCOME SHARES

- Macro-economic: Solow-Swan in competitive economy
- Macro-structural: Influences on rising or falling shares of rents on economy at different times in history
- Micro-structural: the influence of myriad institutional and fiscal arrangements that restrict, enhance or modify the creation, and distribution of rents

SOLOW LETTER TO CORDEN NOVEMBER 14 2017:

"….we conventionally allocate all of the value added to either compensation of labour or return to capital (debt and equity).

"That would be fine if there were perfect competition. In reality, there is a third component, monopoly rent…it gets allocated to labour and capital in unknown proportions.

"What one would like is a 3-way breakdown in market return to labour, market return to capital and rent".

RENT

RENT is income of a factor of or input into production which earns a return in excess of that necessary to attract it to or hold it in the activity in which it is engaged

- exists because a specific resource or input contributes more to value than alternatives
- persists because it cannot be replicated through investment (perhaps because investment is blocked by some institutional or regulatory barrier)
- can be taxed without reducing national output or income

RENT and QUASI-RENT (Marshall)

- Quasi-rent is a return in excess of what is necessary to hold a factor in the use in which it is engaged
- But which is temporary because its continuation depends on continuing investment
- Tax a quasi-rent and you reduce future income and output

RENT SHARE VARIES THROUGH HISTORY

- Changes in dominant sector and technology (agriculture versus large manufacturing versus services versus information technology)
- Changes in political economy (Smith, Marx, Schumpeter, Olson)
- Schumpeterian view that rents support innovation and productive destruction (or did he mean quasi-rents?)
- But downside of Olsonian stagnation and resource curse

SOME RENTS EMERGE IN AN EFFICIENT ECONOMY

Three kinds of efficient rents:

- Protection of exclusive property rights in land and natural resources (avoids free-for-all dissipating value)
- Copyright and patents provide incentives for innovation (but trade-off with value of dissemination defines socially optimal monopoly period)
- Overwhelming economies of scale (natural monopoly eg energy and IT networks)

SOME RENTS INTRODUCE INEFFICIENCY

- Regulation of entry without economic justification
- Use of private market power to restrict competition

SOME ACTIVITIES REFLECT MULTIPLE SOURCES OF RENT

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MOST IMPORTANTLY

- One source of rent may concentrate income and wealth and provide political influence for policy distortion and regulatory rents
- Latter leads to dissipation of talent in rent-seeking activity, away from productive entrepreneurship and public interest policy
- At extreme, resource curse (Sachs, Collier) and extractive dictator (Olson)

TALE OF TWO CAPITALISMS

COMPETITIVE CAPITALISM (KEYNES)
- EGALITARIAN IN LONG RUN

RENTIER CAPITALISM (PICKETTY)
- RETURN OF GILDED AGE AND MARXIAN TENSIONS

Possible reconciliation: Democratic capitalism removing inefficient rents and taxing and regulating efficient rents

Challenge to reconciliation: Capture by wealth of democratic process

ULTIMATELY RESOLVED IN GLOBAL CONTEXT

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- Maturation of global development requires scarce labour and abundant capital everywhere
- Demographic transition comes with successful development
- Transition in successful countries can be overwhelmed by labour growth in failures
- Globalisation necessary for maturation of global development
- A challenge for democratic reconciliation of competitive and rentier capitalism through a long transition