Swimming Upstream:
Policies to Ensure Broadly Shared Prosperity by Restructuring the Market

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Networked Society Meeting
Central European University, Budapest

April 19–20, 2018

The topic of this session is supposed to be alternative policies that can be pursued in Central and Eastern Europe and how international institutions can support them. Since I am skeptical whether international institutions, like the IMF and World Bank, can be expected to support policies to promote equality (they have more often been on the other side), I will suggest policies that can advance with or without their support.

These policies are in six general areas:

1) Macroeconomic and full employment — the overall level of output and employment can largely be determined by policy and has an enormous impact on the distribution of income.

2) Policies on patents, copyrights, and other claims to intellectual property —technology doesn't generate inequality; rules on the ownership of technology generate inequality.

3) Rules on corporate governance that determine control over corporate profits — CEOs get outrageous paychecks because they get to set their own pay.

4) Rules on finance, including the taxation of financial transactions — many of the highest earners get their money through economically worthless shuffling of financial assets.

5) Protectionism of highly paid professionals such as doctors and lawyers — high-end professionals aren't rich because of the market, but because of protectionism.

6) Competition policy — when governments let huge companies like Facebook buy up potential competitors, it leads to inequality.

In all six areas, international agreements limit the ability of individual countries to act, but they do not eliminate it. Countries should push policies as far as possible to try to get around existing constraints.

Macroeconomic Policy and Full Employment

This is the most important single area for policies that promote equality rather than inequality. Most people get most of their income through their jobs. This is somewhat less true in countries with more generous welfare states, but even in the most generous welfare states, wage income is hugely important. Maintaining high levels of employment allows workers to get jobs if they want them. Also, a high employment environment gives the workers who are employed more bargaining power. This tends to disproportionately benefit those who are at the bottom of the income distribution.[1] For these reasons, governments should place a high priority on maintaining full employment.

Unfortunately, many European countries have sharply limited their ability to promote full employment policies by their commitments to the European Union (EU) and through joining the euro. The former has placed sharp restrictions on countries' ability to run budget deficits. These restrictions seem to stem from the view that deficits crowd out private investment and/or lead to inflation.

While there can be circumstances in which large budget deficits do lead to higher interest rates and/or inflation, this has not been a problem in recent years in European countries. These countries have clearly been suffering from too little demand, not too much. Countries should take advantage of whatever flexibility they have to run larger deficits when necessary to maintain high levels of employment. There clearly is some room in this area, since enforcement has not been rigid. Also, insofar as progressive governments have a role in setting EU policy, they should push for more flexibility in setting fiscal policy.

The countries that are part of the euro have stricter constraints in all areas of macro policy. The European Central Bank (ECB) has the ability to put sharp limits on borrowing by countries it considers to be irresponsible, as we saw in the case of Greece in 2015. Being part of the euro also means that monetary policy is set by the ECB. Furthermore, there is no ability to use exchange rate policy as a mechanism to boost output and employment, since this will depend on the course of the

1 This is clearly true in the United States, see Dean Baker and Jared Bernstein, 2013, *Getting Back to Full Employment: A Better Bargain for Working People*, Washington, DC: Center for Economic and Policy Research. http://cepr.net/documents/Getting-Back-to-Full-Employment_20131118.pdf.

euro. Here also governments can use their limited power within the euro to push for more expansionary policy.[2]

Even if governments are prevented from pursuing more expansionary macro policy they still can act to ensure that available employment is more evenly distributed. One mechanism for doing this is promoting work sharing as a substitute for layoffs in a downturn. The idea is to compensate workers for reduced hours while they remain employed, as opposed to providing them with unemployment compensation for being unemployed. This is likely to lead to a much smaller drop in income and also keep workers tied to the labor force so that they don't lose skills after a long period of unemployment.

Governments should also implement policies like mandatory paid vacations, paid family leave, and paid sick days, as both ways to meet important social goals and to share the work that is available. Shorter standard workweeks are also an option. These practices have led to enormous differences in average annual hours across countries. According to OECD data, in an average year a worker in the United States puts in 1785 hours, this compares to 1365 hours in Germany and 1430 in the Netherlands. These policies are entirely under the control of national, or even sub-national, governments.[3]

Rules on Patents, Copyrights, and Other Forms of Intellectual Property

This is an enormously important, and often overlooked, area of policy. It has become common in the last few decades to blame technology for rising inequality. This is incredibly sloppy thinking. The returns to technology are not determined by the technology, but by the laws that govern the ownership of the technology. Specifically, it is rules on patents, copyrights and other forms of intellectual property that have allowed some segments of society to get very wealthy from various types of innovations.

To take an extreme case, if there were no patent or copyright protections, the robots that are supposed to take all of our jobs would be incredibly cheap. They can presumably be made by robots and they don't require that much by way of steel or other materials or energy in the production process. For a few hundred dollars we could all buy robots that would cook our dinners, mow our

2 Fortunately, most of the former East Bloc countries have not joined the euro, with the exceptions being the Baltic countries, Slovakia, and Slovenia.

3 In the United States, many states and cities have passed laws or ordinances in the last two decades guaranteeing workers varying levels of paid family leave and/or paid sick days.

lawns, wash our clothes, and clean our houses. This would mean a huge improvement in living standards for the bulk of the population. No one would be able to make large amounts of money from the robots since competition would drive prices down to near the cost of production.

The world in which some people get very rich from "owning" robots and the rest of the country gets poor from being displaced is a world in which the government has granted patent and/or copyright monopolies that keep the robots expensive. It is not the robots causing inequality in this story, it is the patents and copyrights.

The policy part of the picture is rarely discussed. There is, of course, a rationale for patents and copyrights, they provide an incentive for innovation and creative work. However, we could opt to provide less incentive — we need to decide the right incentive based on the incremental amount of innovation work compared with the additional cost imposed by these protections. There are also alternative mechanisms for financing innovation and creative work which are arguably more efficient and would lead to less inequality.[4]

There is an enormous amount of money at stake in these protections. In the United States, patent and related protections add close to $400 billion (2.0 percent of GDP) to annual spending on prescription drugs alone. Adding in the costs in other areas could take this sum to more than $1 trillion a year.

In the last four decades, the United States has made patent and copyright protection longer and stronger and sought to impose these rules internationally through trade agreements, like the TRIPS provisions in the WTO. It would likely be good for both growth and equality for the countries of Central and Eastern Europe to take full advantage of the flexibilities in TRIPS and other trade agreements to minimize the cost of these protections. They should also use their voice in international forums to argue against making these rules even stronger as would be the case with the Trans-Pacific Partnership or Trans-Atlantic Trade and Investment Pact.

4 See Dean Baker, Arjun Jayadev, and Joseph Stiglitz, 2017, "Innovation, Intellectual Property and Development: A Better Set of Approaches for the 21st Century," Washington, DC; Center for Economic and Policy Research. http://cepr.net/publications/reports/innovation-intellectual-property-and-development-a-better-set-of-approaches-for-the-21st-century.

Rules on Corporate Governance: Reining in CEO Pay

The pay of CEOs in the United States has exploded in the last four decades, going from 20 to 30 times the pay of ordinary workers to 200 to 300 times the pay of ordinary workers. While the United States is still an outlier on CEO pay, the extraordinary pay of CEOs in the United States is putting upward pressure on pay structures in other countries.

It is difficult to justify the explosion of CEO pay by their productivity in any obvious way. CEOs of major companies are expected to work hard and have enormous responsibilities, but this was true forty years ago also. There is also little relationship between pay and performance, measured as returns to shareholders.

Many CEOs are able to get outsized paychecks even when they have done nothing obvious to benefit shareholders. For example, the top executives at major oil companies were highly rewarded for the jump in oil prices in the middle of the last decade that sent oil company profits soaring.

Rather than being based on value to the shareholders, the most obvious explanation for high CEO pay is that they largely control the Boards of Directors who most immediately determine their pay. Directors often owe their selection to top management. Once they are on the board, directors who manage to fit in well with other directors almost never get removed by shareholders. More than 99 percent of incumbent directors who are put up by the board for re-election, end up winning their seat.

In this context, directors have almost no incentive to ever ask about reducing CEO pay. Being a director of a major corporation typically pays over $100,000 a year, and sometimes more than $200,000) for extremely part-time work. Since they can pretty much keep their job indefinitely if they go along with the rest of the board and not complain about CEO, directors have no reason to act in the interest of shareholders and try to push down the pay of their CEO.

The rules of corporate governance are set by country governments. (In the United States, individual states have their own rules.) It is strongly desirable to have rules that ensure that shareholders have the ability to control CEO pay. This can be done with provisions on transparency, votes of shareholders on pay packages, and penalties to corporate boards for allowing excessive pay.[5]

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5 The 2010 Dodd-Frank financial reform bill in the United States called for tri-annual “Say on Pay” votes on executive compensation by shareholders. These votes are a non-binding up or down vote on the CEO pay package. These votes might have

The issue of CEO pay is important both for its impact on pay within the corporation, but also outside. If the CEO of a major company is earning $20–$25 million a year, it's likely that her next-in-line executives are also getting compensation packages well into the millions. And more money for those at the top means less for everyone else, pretty much by definition.

In addition, high CEO pay spills over into other sectors. In the United States, it is common for university presidents or heads of major charities to get pay packages of over $1 million a year because they could earn so much more if they were in the corporate sector.

We would likely see a very different pay structure throughout the economy if the CEOs of major corporations were still earning 20 to 30 times the pay of ordinary workers (e.g. $2–$3 million in the United States). If the very top of the pay scale was in this range, the pay of the next tier of executives would likely be close to $1 million, with pay at universities and major charities topping out at well under $1 million. This would free up a substantial sum of money for less highly paid workers.

Reining in the Financial Sector

The financial sector has exploded relative to the rest of the economy throughout the industrialized world. In the United States, the narrow financial sector (investment banking and securities and commodities trading) has nearly quintupled relative to the size of the economy over the last four decades, going from just over 0.5 percent of GDP in the 1970s to almost 2.5 percent of GDP in recent years.

It is difficult to see how the economy is benefitting from this much larger financial sector. It is certainly not obvious that capital is being better allocated in recent years than it was in the 1960s and 1970s. Nor is it likely that people feel more secure in their savings, especially after the 2008 financial crisis.

If the growth in the relative size of the financial sector is not benefitting the economy, then it amounts to a major source of waste. The gap between the current size of the sector and the mid-1970s size is almost 2.0 percent of GDP or $400 billion a year. Furthermore, many of the highest income earners are in the financial sector, so this is also a major driver of inequality.

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more impact if directors faced some consequence from a pay package voted down, for example if they lost stipend for the year. That would likely force them to ask more frequently whether they could pay their CEO less.

For these reasons, it is desirable to have policies that focus on reducing the size of the financial sector, thereby limiting the resources consumed by this sector. One obvious route for downsizing this sector is a financial transactions tax (FTT). Because trading costs have fallen so sharply in recent years, many trades are done in the expectation of modest gains. In this context, even a small FTT can have a large impact in reducing the size of the sector and the fortunes being made by shuffling paper. FTTs enjoy substantial support across the EU, although implementation of a tax keeps being put off for reasons that I don't fully understand.

In addition to an FTT, it would be desirable to take other measures to downsize the financial sector. In the United States, private equity companies have hugely expanded their reach in the last decade. These companies are expert at manipulating the tax code, so they can often make large gains by acquiring marginally profitable companies.

A standard trick was to borrow heavily against the assets of a firm they acquire, taking advantage of the deduction for interest on borrowed money, as opposed to dividends paid to shareholders, which are not deductible on federal tax returns. This was changed in the 2017 tax reform, which limited the deduction to an amount equal to 30 percent of the company's profits.

It would be desirable to comb the tax code for unnecessary complexities which help to provide profits for private equity companies and the larger tax avoidance industry. One route that would eliminate many loopholes is replacing the corporate income tax with a quasi-equity stake.[6] This quasi-equity stake would give the government ownership of a number of non-voting shares equal to the targeted tax rate. For example, if the desired tax rate is 25 percent, then the number of shares given to the government should be equal to 25 percent of total shares.

The government's shares would give it no control over the company, but they would otherwise be treated in the same way as other shares. If the company paid a $2 dividend per share, then it also would pay a $2 dividend on the government's shares. If it bought back 10 percent of its shares at $100 per share, then it would also buy back 10 percent of the government's shares at $100 per share. This would make it virtually impossible for the company to escape its income tax liability and in the process would destroy the tax shelter industry.

6 See, for example, https://ftalphaville.ft.com/2017/10/31/2195336/the-most-elegant-corporate-tax-reform/.

There is one other fundamental point on finance that is currently taking center stage in public policy in the United States.[7] It is a fairly straightforward proposition that experts in law and accounting can write contracts that the average consumer will not understand. Most people are not experts in contract law and will not take the time to study a contract they might sign for a credit card, car loan, or home mortgage. For this reason, it is good policy to standardize these contracts and make abusive ones unenforceable.

This is not just a question of protecting people who may be less sophisticated in dealing with legal and financial matters, it is also a matter of promoting efficiency. If it is very profitable to write deceptive contracts, then highly educated people will spend lots of time writing deceptive contracts. This is a pure waste from an economic perspective, as is the extra time that consumers have to spend scrutinizing their contracts. Requiring that contracts be simple and standardized is a great way to prevent people from getting rich by ripping off their customers.

Ending Protection for Highly Paid Professionals

There is a tendency to believe that global trade is only a problem for less-educated workers. There are of course hundreds of millions of people in developing countries who are happy to work in factories for a fraction of the pay of their counterparts in the rich countries. The competition with these lower paid workers has led to the loss of millions of manufacturing jobs in rich countries and placed downward pressure on the wages of the remaining jobs. There is also a spillover effect since manufacturing has historically been a source of relatively high-paying jobs for less-educated workers. When these jobs disappear, the displaced workers effectively increase the supply of labor in other sectors, putting downward pressure on the pay of less-educated workers in retail and other services.

The fact that competition with workers in the developing world primarily affects less-educated workers is a policy choice, not a natural market outcome. There are also tens of millions of workers in the developing world who are highly educated as physicians, dentists, accountants and other professionals, who would be happy to work for a fraction of the pay of their counterparts in rich countries. While trade policy has been quite explicitly designed to make less-educated workers compete with workers in the developing world, the barriers that protect highly paid professionals have been largely left in place.

7 The Trump administration is trying to dismantle the Consumer Financial Protection Bureau that was created by the Dodd-Frank financial reform bill. It also is attempting to reverse the "Fiduciary Rule" put in place by the Labor Department under the Obama administration. This rule requires financial advisers to act in the interests of their clients. Many advisers are paid by third parties to steer clients into funds which may not be good investments for them.

This is especially the case in the United States. To practice as a physician in the United States it is necessary to complete a US residency program.[8] Both the number of residents and the number of slots reserved for foreign medical school graduates are tightly restricted. As a result, doctors in the United States earn on average more than $260,000 a year, roughly twice the average for their counterparts in other wealthy countries. There is a similar story with dentists who must graduate from a dental school in the United States to practice.

While the barriers to foreign professionals are less extreme in other countries in almost all cases, unnecessary barriers block the entry of qualified professionals. Removing these barriers would both reduce the income of some of the most highly paid workers and effectively raise the wages of the rest of the workforce by lowering the price of the services these professionals provide. This is just the standard argument for trade. Just as lower-priced clothes and shoes from the developing world effectively raise the wages of workers in rich countries, so would lower-priced medical care, dental care, and legal and accounting services.

Pushing for a policy of free trade in highly paid professional services also has the benefit of pointing out that the big gainers in the global economy were not successful because of their education and skills, but because they were able to secure protections for themselves. The problem for less-educated workers in the global economy is not their lack of skills, but rather their lack of political power to protect themselves in the same way.

There is a real issue of "brain-drain" from developing countries, in which they pay for the education of workers only to see them practice their professions in the rich countries. This can be addressed with a policy of compensating poorer countries for their loss of educated workers. The gains to rich countries are so large that it should be possible for them to provide enough money to educate two or three developing country professionals for every one that emigrates to a rich country. The mechanics for this should not be difficult since these are licensed professions where workers have to provide a record of their education in order to work, so there is not going to be a major problem of workers going untracked by governments.

8 Recently, doctors who completed a residency program in Canada have also been allowed to practice in the U.S., although they still must go through an extensive testing process in addition to the residency.

Competition Policy: Monopolies Do Lead to Inequality

There has been to a large extent an abandonment of competition policy in rich countries over the last four decades, especially in the United States. Many of the largest firms have openly engaged in classic anti-competitive practices with little or no opposition from regulatory bodies.

For example, at the end of the 1980s and early 1990s, Microsoft signed contracts with the major computer manufacturers under which they paid the company for each computer they shipped, regardless of whether or not it used the Microsoft operating system. This was ostensibly for the purpose of reducing monitoring costs, but it meant that computer makers would effectively be paying for two operating systems if it chose to install an operating system developed by a competitor.

This was at a time when Microsoft was locking up a new monopoly in the operating system market. While no competitor may have realistically been able to replace Microsoft as a core provider, it is possible that competitors might have developed for niche markets from which they could potentially expand. These contracts largely precluded this possibility. The US Justice Department did investigate this practice and in 1993 got an agreement from Microsoft to stop using these contracts, but there were no penalties and no effort to restore competition to the market.

In the same vein, Facebook has been allowed to buy up a number of potential competitors, including Instagram and WhatsApp, for the explicit purpose of eliminating a potential competitor. These purchases were allowed to go through for the most part without even a serious investigation of the implications for competition in the market. This sort of anti-competitive behavior almost certainly would not have been allowed with the anti-trust policy that was in place in the United States forty years ago.

Microsoft, Facebook, and Google have all used their near monopolies to expand into other sectors, where their monopoly position provides them with huge advantages over competitors. For example, Microsoft has moved into a wide variety of software applications that were designed to work with its operating systems. Google has moved into the browser market. It should seem a straightforward anti-trust matter that if these platform monopolies are allowed to persist, then the companies should be prohibited from using the power provided by them to get a privileged position in other markets.

This means separating these monopolies from other segments of the company that might be operating in more competitive markets.[9]

There are many other areas in which anti-trust issues have arisen where the case may be less clear; however, there can be little doubt that the United States and other wealthy countries have been far less committed to promoting competition policy than was the case four decades ago. Monopolies, or near monopolies, in many sectors have played an important role in the upward redistribution of income.

In Europe, competition policy is largely under the control of the EU, however individual countries still have considerable control over their tax policy. It is entirely appropriate for countries to apply special taxes to sectors where there is clear evidence of monopoly profits. The criteria for higher "monopoly" taxes should be clearly specified so that companies know how to act to avoid them and also so that they are not applied arbitrarily.

Countries can also use their voice in the EU to push for more aggressive competition policy. The EU has been considerably stronger in addressing anti-trust issues than the United States, but it can still go much further in reining in anti-competitive practices. Ultimately, it is much better to have policies that break up or regulate monopolies to ensure they don't have excess profits in the first place, rather than tax profits away after the fact.

Countries should also be careful of entering trade agreements that would limit their ability to regulate these monopolies or near monopolies. Provisions on "e-commerce" in the Trans-Pacific Partnership and the Trans-Atlantic Trade and Investment Pact could have made it more difficult for the parties to establish control over foreign-based corporations like Google or Facebook.

9 This separation was actually the central feature of a district court judge's ruling against Microsoft in anti-trust case brought by the Clinton administration in the late 1990s. After being found guilty, Microsoft was able to move the case to a different judge, who applied much weaker sanctions.

Conclusion

There have been a variety of policies put in place in most wealthy countries over the last four decades which have had the effect of redistributing a large portion of national income from the middle and bottom to those at the top. These policies have been focused on changing market outcomes (the upward redistribution was primarily in before-tax and transfer income), which has led many to believe that the upward redistribution was an inevitable result of globalization and technology. This is clearly not true.

Just as policy was crafted to redistribute upward, market structures can be redesigned to produce more equal outcomes. This sort of shift is essential if the bulk of the public is going to support liberal democratic political parties. Economic policies that result in the bulk of the gains going to those at the top, with little progress for most workers, will not enjoy political support. The public will inevitably turn to politicians who can promise a better future. If they don't see politicians committed to liberal democracy making plausible commitments in this direction, they will turn to politicians promising a better future at the expense of immigrants and minorities.