

Ralph Miliband Programme: the future of the left

Toward Economic Feudalism? Inequality, Financialisation, and Democracy

Professor Richard B Freeman

Herbert Ascherman Chair in Economics, Harvard University

Dr Robin Archer

Chair, LSE

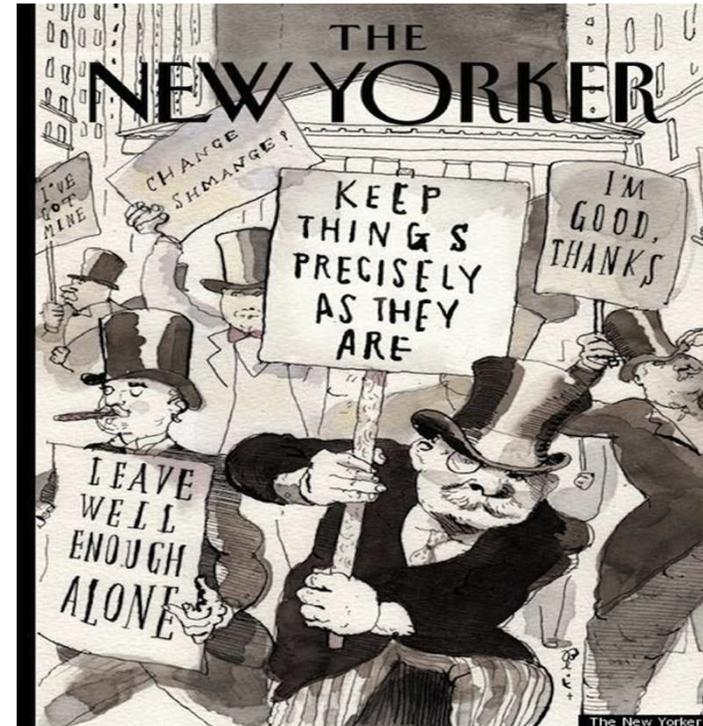
LSE events

Suggested hashtag for Twitter users:
#lsefreeman



Toward Economic Feudalism?

Inequality, Financialization, and Democracy in the Global Economy



Richard B. Freeman, Harvard, NBER, and CEP, LSE
Milliband Lecture May 2, 2012

**The Issue: Huge Inequality in Market Earnings →
Inequality in Politics --> crony capitalist behavior to
preserve the inequality, producing Economic Feudalism**



“We may have democracy,
or we may have wealth
concentrated in the hands of
a few, but we can't have
both” – Justice Brandeis

As Gordon says, “We make the
rules, pal ... you're not naive
enough to think we're living in a
democracy If you're not inside,
you're 'outside'.”



This talk:

1 - Inequality and financialization

2 - Economic feudalism: regulatory and political capture

3 – Hazchem!

4 – Building Market Democracy Anew: ICT & Collective Intelligence

1. Rising inequality and financialization



Wall Street Occupiers emphasize the upper 1%, whose share of income rose from 9.03% in 1977 to 23.5% in 2007.

But the upper 0.1% gained the most. Share of pretax income earned by top 0.1% increased from 2.7% (1977) to 12.3% (2007), which is 66% of increase to upper 1%. (Smaller increase through 2010 because stock market fell.)

Who are the 0.1%? Two-thirds are executives, managers, supervisors, financial professions + real estate

Focus on 0.1% is also wrong: income is power law

Within the 0.1% , 48% of income goes to upper 0.01% and within upper 0.01% , 49% of income goes to upper 0.001%.

In 2007 (latest year) top 400 US taxpayers (0.00028% of 142,978,806 total returns) earned 1.59% of adjusted growth income in country, up from 0.52% in 1992: 10% of capital gains, 4% of interest, 4% of dividends. Top 400 is 5,770 times average adjusted gross income.

Inequality among faculty at doctorate-granting institutions,

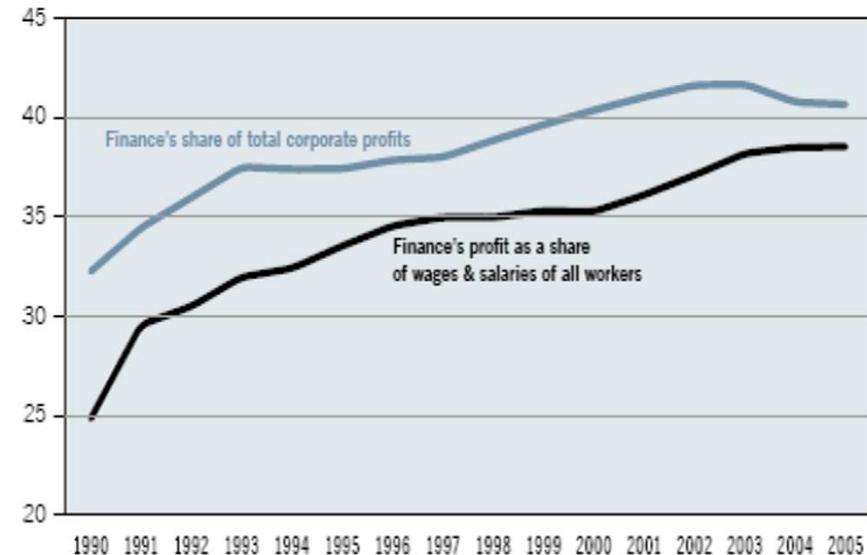
Gini Coefficient	1973	1985	1995	2006
Life Sciences				
Assistant	.091	.098	.190	.228
Associate	.088	.115	.168	.223
Full	.120	.128	.206	.250

Finance did better than it had before the 1929 Crash and Great Depression



Source: Philippon, 2008

Figure 2.1 The rising incidence of profits of the financial sector in advanced economies, 1990–2005

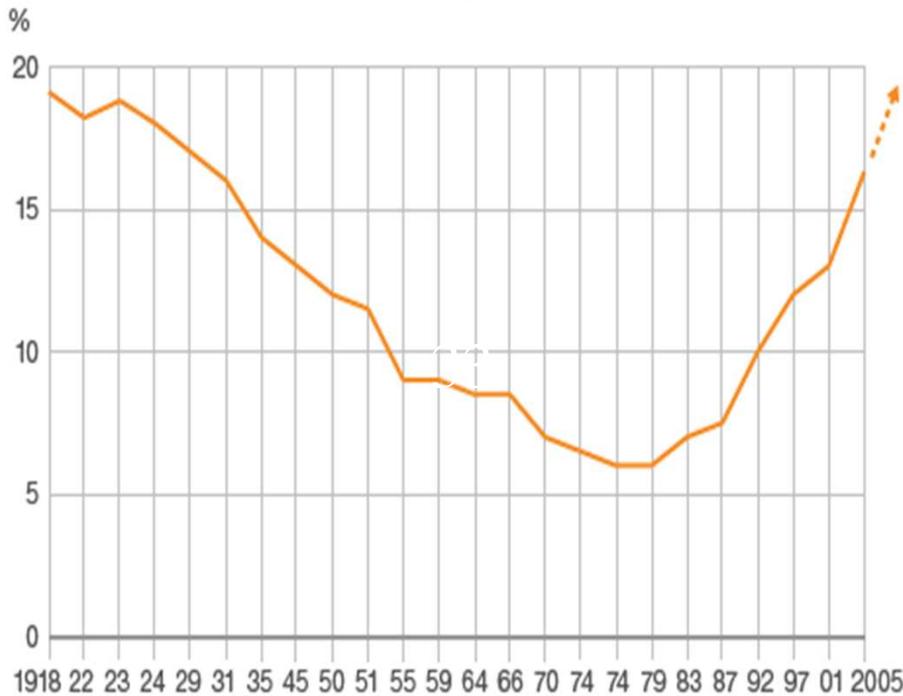


Compensation per FTE employee for security and commodity brokers rose from 146% to 290% above the national average between 1990 and 2007. **Total compensation bill for security and commodity brokers went from 31% to 93% of the compensation for federal civilian employees.**

UK more “modest” inequality

	upper 1%	0.1%	0.05%
1979:	5.9%	3.1	2.3
2007	15.4%	6.1	4.5

Share of all income received by the richest 1% in Britain

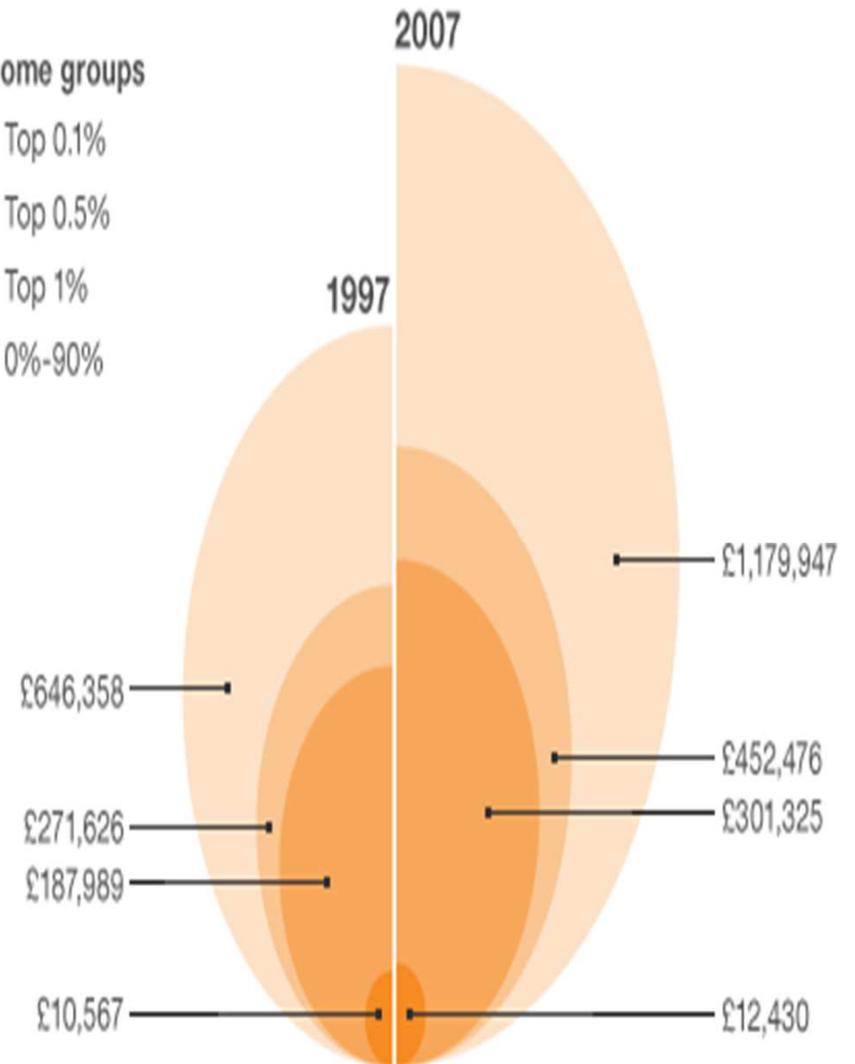


Source: Danny Dorling - Fair Play, The Policy Press, 2012

Average incomes for selected groups in the UK

Income groups

- Top 0.1%
- Top 0.5%
- Top 1%
- 0%-90%



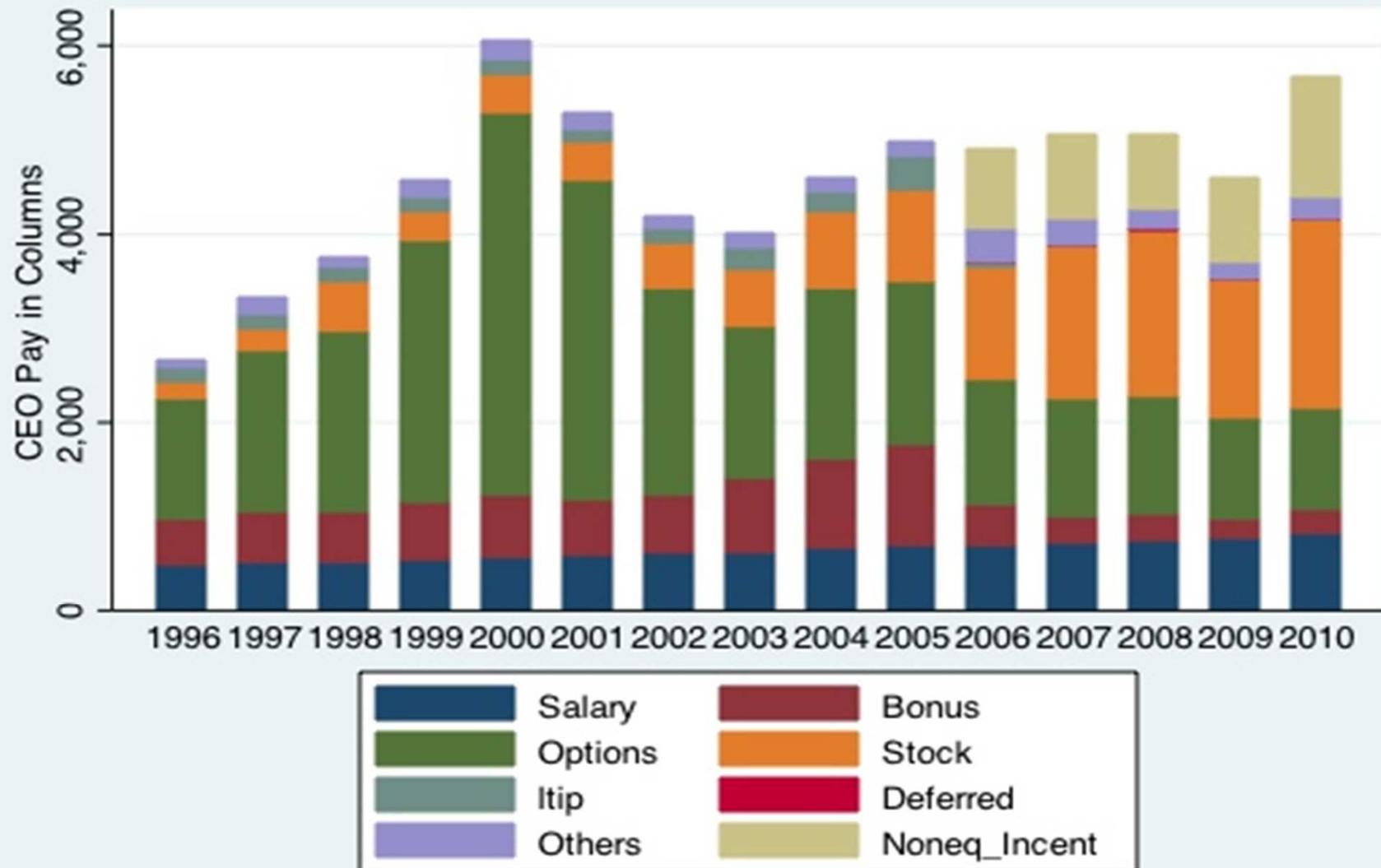
Source: BBC The Wealth Gap analysis from WTIB data

Two hypotheses to explain rising inequality

H1: Efficient production. Modern ITC augments management's span of control and turns top execs into superstars in global economy. "Bosses and financiers (aka job creators) deserve what they get. Do what you're told or the good ship capitalism will sink like the Titanic."

H2: Successful rent-seeking. Small elite controls business and government and extracts economic rents, mostly through capital income. Finance is the center, with banks-too-big-to-fail aka "vampire squid(s)" that must be fed huge sums regularly or else.

Mechanism in US is by linking earnings of top executives to capital income as incentive pay.



Filling in the Two Hypotheses

	Efficiency View	Rent-Seeking View
1	Execs make key decisions, rest of firm does not matter much, so exec MP is high	Teams make decisions, exec is more manager/coach than star athlete; chance important in outcomes.
2	Independent boards bargain exec contracts in competitive market	Executives control corp governance, appoint boards, hire “Arthur Anderson” compensation consultants
3	Contracts solve principal agent/adjust toward efficiency	Execs game contracts through financial manipulation/insider info
4.	Exec does nothing but huge pay/perks at top motivates employees in tournament to reach top – socially efficient/individuals rent-seek	
5.	High pay benefits firm as execs' buy political influence; regulators/politicians make “right decisions” in hope that firm will hire them at high pay when they leave public sector.	

Do big incentives at top improve firm performance, share price, growth of productivity, employment?

Lots of debate about share price but evidence is weak.

If firm does well executives do well (Hall & Liebman, 1998); Execs do much better than others (Bell & Van Reenen, 2012). Large option \rightarrow lower future share price (Cooper, Gulen, Rau Feb 2011). One reason could be that firm is lucky in period one, grant options, and regresses to mean.

“Correct” measure of incentive is $d[\text{BS value of options} + \text{shares owned}]d \text{ Share price}$. This incentive has modest positive/negative effect on future prices depending on X,Y,Z. But compensation package is endogenous. Board should set optimally to have zero marginal effect. Execs hedge options, weakening incentives (Bettis, et al, 2010).

Evidence of Rent-seeking: Who gets what when share prices change independent of exec decisions

Oil price shock (Bertrand and Mullainathan, 2001)

9-11 Execs ladle out options after 9/11 attack – denounced as “sleaze balls and profiteering ghouls” by HBR editor.

Firms give “unscheduled” options before analysts announce positive buy recommendation or expect share prices to rise.

Many firms backdated options so they look as if given in valley of price; Sarbanes Oxley 2-day rule curtails this

Response to “under water” options: 81% act to restore exec wealth --re-priced options, then shifted to “6 and 1” option to avoid FASB ruling. Give “unexpected bonus or options” (Balachandran, et al 2004). Raise salary (Bianchi, 2012)

JANUARY 18, 2011, 9:40 PM

Study Points to Windfall for Goldman Partners

By *SUSANNE CRAIG* and *ERIC DASH*

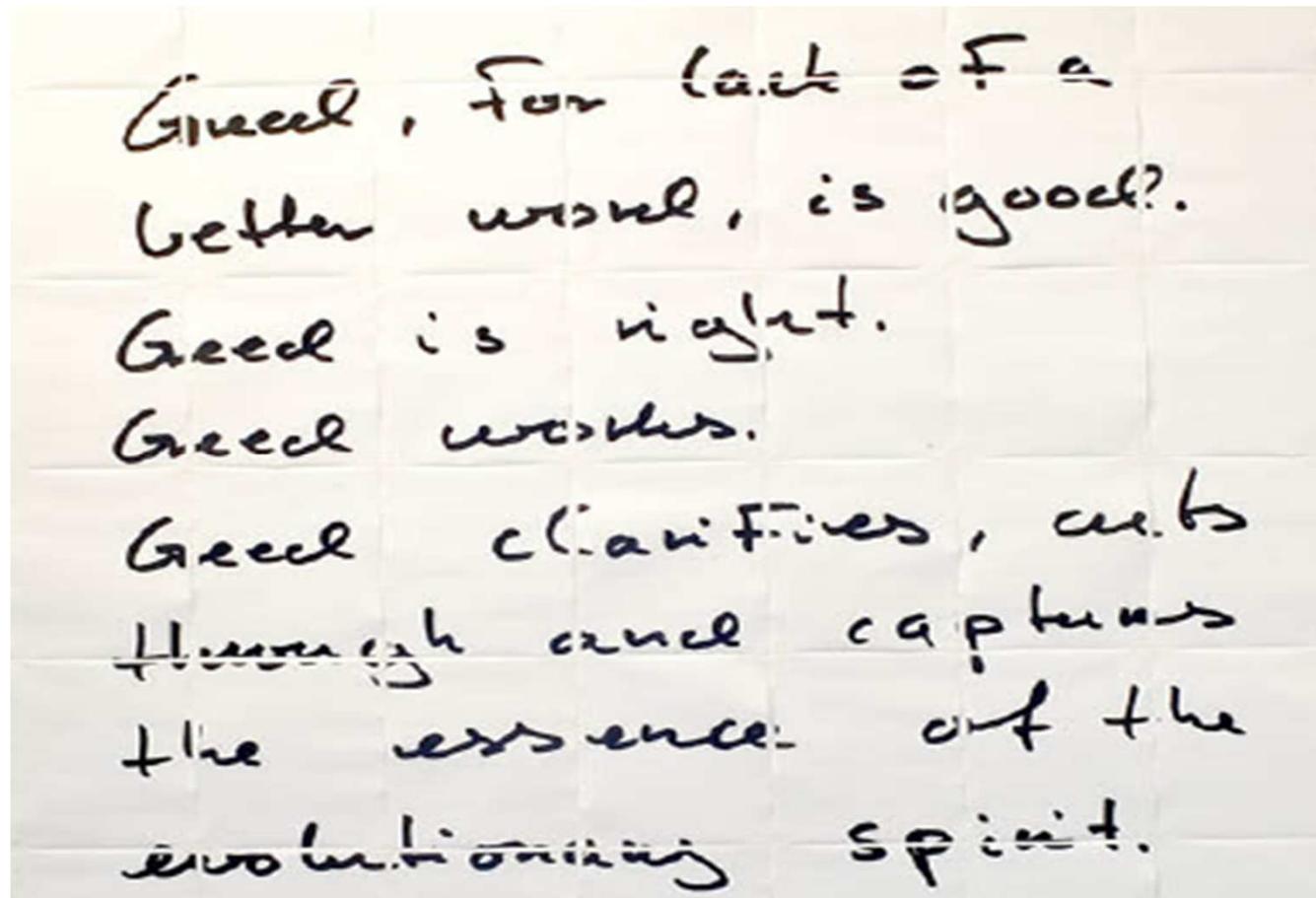
Goldman Sachs executives have long been among the most richly paid on Wall Street in the best of times. They are now poised to reap a windfall that was sown in the dark days of the financial crisis in 2008.

Nearly 36 million stock options were granted to employees in December 2008 – 10 times the amount issued the previous year – when the stock was trading at \$78.78. Since those uncertain days, Goldman's business has roared back and its share price has more than doubled, closing on Tuesday at nearly \$175.



What economics predicts

Execs and wealthy (like everyone else) follow self-interest, have greater incentives and more tools/power to get what they want. Homo oeconomicus:



Greed, for lack of a
better word, is good?
Greed is right.
Greed works.
Greed clarifies, cuts
through and captures
the essence of the
evolutionary spirit.

2. Toward Economic Feudalism

In the councils of government, we must guard against the acquisition of unwarranted influence by Wall Street and the super-wealthy in a highly unequal economy . The potential for the disastrous rise of misplaced power exists and will persist... Only an alert and knowledgeable citizenry can provide the countervailing power to assure that the country prospers together.

The prospect of public discourse controlled by an ideological communication media and the funding of research by foundations supported by the wealthy few is gravely to be regarded ... public policy could itself become the captive of a wealthy elite who see the preservation of the status quo of inequality as the appropriate goal for the nation.

“Dwight Eisenhower Military-Industrial Complex speech
(Jan 26, 1961 updated for May 2, 2012)

IMF Chief Economists ...

“financiers... played a central role in creating the crisis, making ever-larger gambles, with the implicit backing of the government ...(and) are now using their influence to prevent ... reforms ... **One channel of influence was, of course, the flow of individuals between Wall Street and Washington.** Robert Rubin,... Henry Paulson, ... John Snow, Paulson’s predecessor, ... Alan Greenspan became a consultant to Pimco,” (biggest player in international bond markets). Simon Johnson

“Perhaps the single biggest distortion ... is when ... private institutions are deemed by political and regulatory authorities as too systemic to fail. ... these institutions can play a game of chicken ... confident in the knowledge the authorities will come to the rescue when needed. The consequences are **observationally identical to those in a system of crony capitalism.** ... two sets of rules, one for the systemically important, and another for the rest of us.” Raghuram Rajan

Capturing or Squashing the regulators

“in youth (regulatory agencies) are vigorous, aggressive ...

Later they mellow, and in old age-- after a matter of ten or fifteen years – they become ... either an arm of the industry they are regulating or senile.” (JK Galbraith)

“Off with her head!” Brooksley K Born, head of Commodity Future Exchange Commission, warns of lack of transparency, excess leverage, prudential controls in US financial markets from fall 1998 to spring 1999. Rubin, Summers, Levitt squelch her for “cast(ing) the shadow of regulatory uncertainty over an otherwise thriving market”.

“When the money is rolling in you don't ask how ... when the money keeps rolling out, you don't keep books ... Accountants only slow things down, figures get in the way.”

The Nightmare on K street



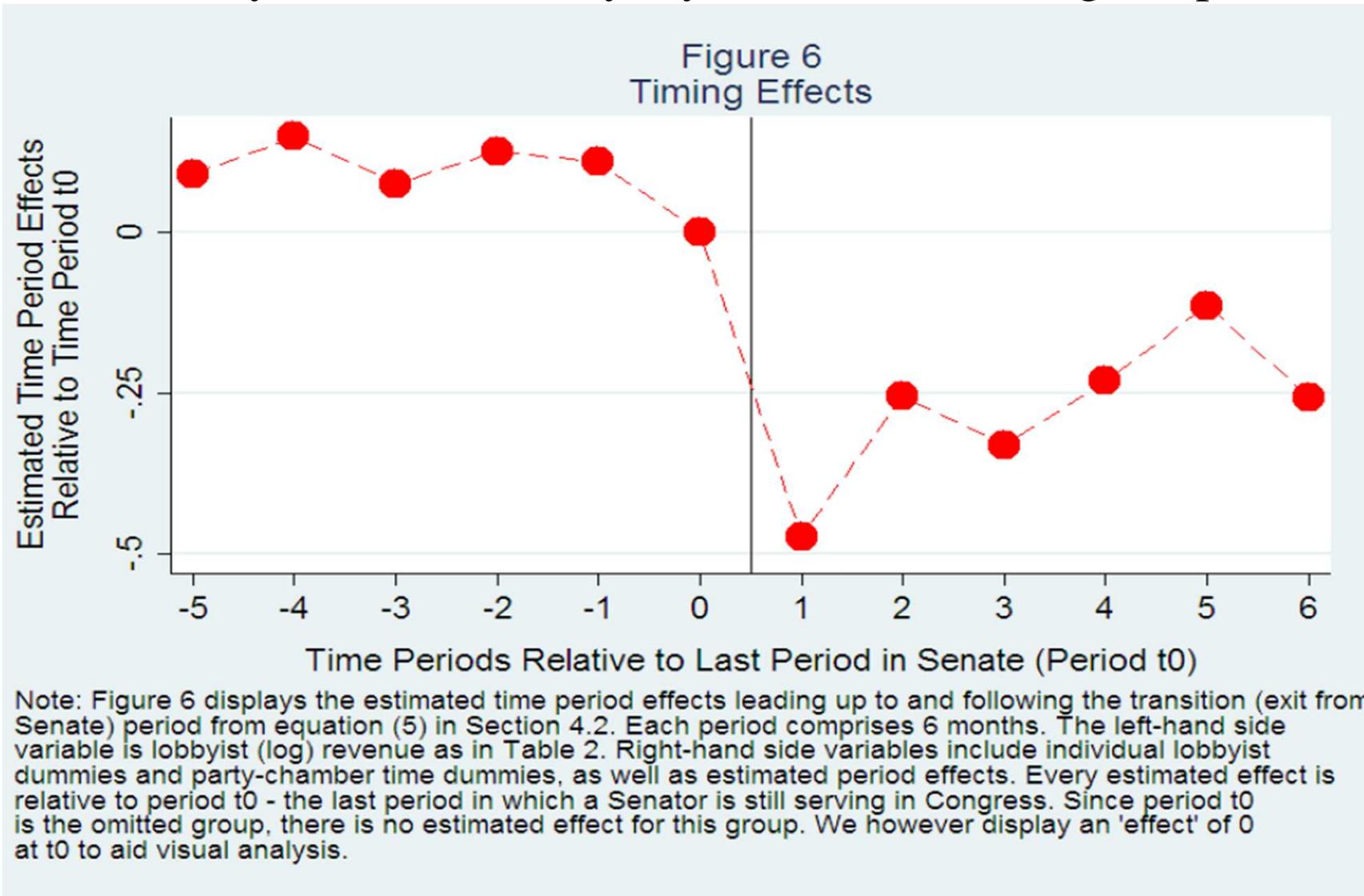
In 2005, US had ~ 35,000 registered lobbyists for Congress. Lobbyists target the Senate, the House, and state legislatures. They represent their clients' or organizations' interests in dealings with federal, state, or local agencies or courts. Lobbyists sometimes write legislation.

Since 1998, 43% of the 198 members of Congress who left government to join private life registered to lobby. Former lawmakers are hired as lobbyists because of relationships with former colleagues as well as other contacts.

In 2006, 273 former members of Congress or heads of federal agency were lobbyists.

In 2007, finance had 2,996 lobbyists in DC.

How Lobbyists Make Money: by link to “their Congress person”



Jordi Blanes i Vidal Mirko Draca, Christian Fons-Rosen. “Revolving Door Lobbyists”, AER forthcoming

Capturing the Politicians

Hi, Congressman. Our PAC has twice as much money as we had last year when we supported you. We are very interested in having a special amendment put in on the new regulatory/tax/ bill. Here is the amendment. We hope to be able to contribute to you again. We are certain someone will be running in your district favorable to our amendment.”

'I've never asked a prime minister for anything... I, in 10 years in his power there, never asked Tony Blair for any favors and never received any,"

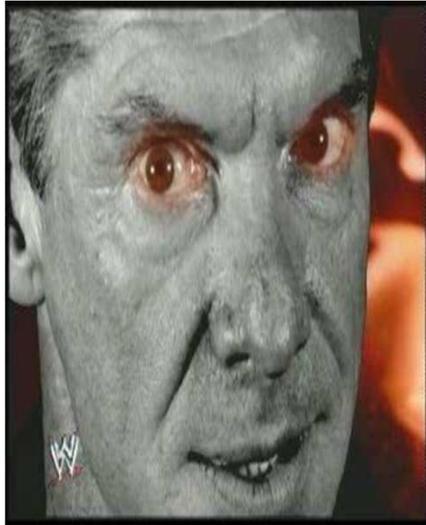


Resilience of the Cronies

“You learn more about society in crisis than in normal times”

2008 naïve economist view that US would respond to finance crisis and recovery by doing what worked in 1980s S&L loans crisis-- take over failed banks, get rid of management, have FDIC run banks, sell them to private sector in a few years when they are cleaned up. Create competitive market with smaller banks. Prosecute/fine top bankers. Maybe even break up big banks. As for the bankers, they would lie low, take \$1 million pay checks, thank taxpayers for bailing them out, work to reform system.

Lie low, cut our pay and power? Never!



Helpline from legal/political system

US Supreme Court June 2010 decision on Enron said the law that firms/public has an "intangible right of honest services" used to prosecute Enron and politicians is too vague. This opens door for more legal gaming.

Citizens United decision (January 2010) → SUPERPACS in politics.

Congress:

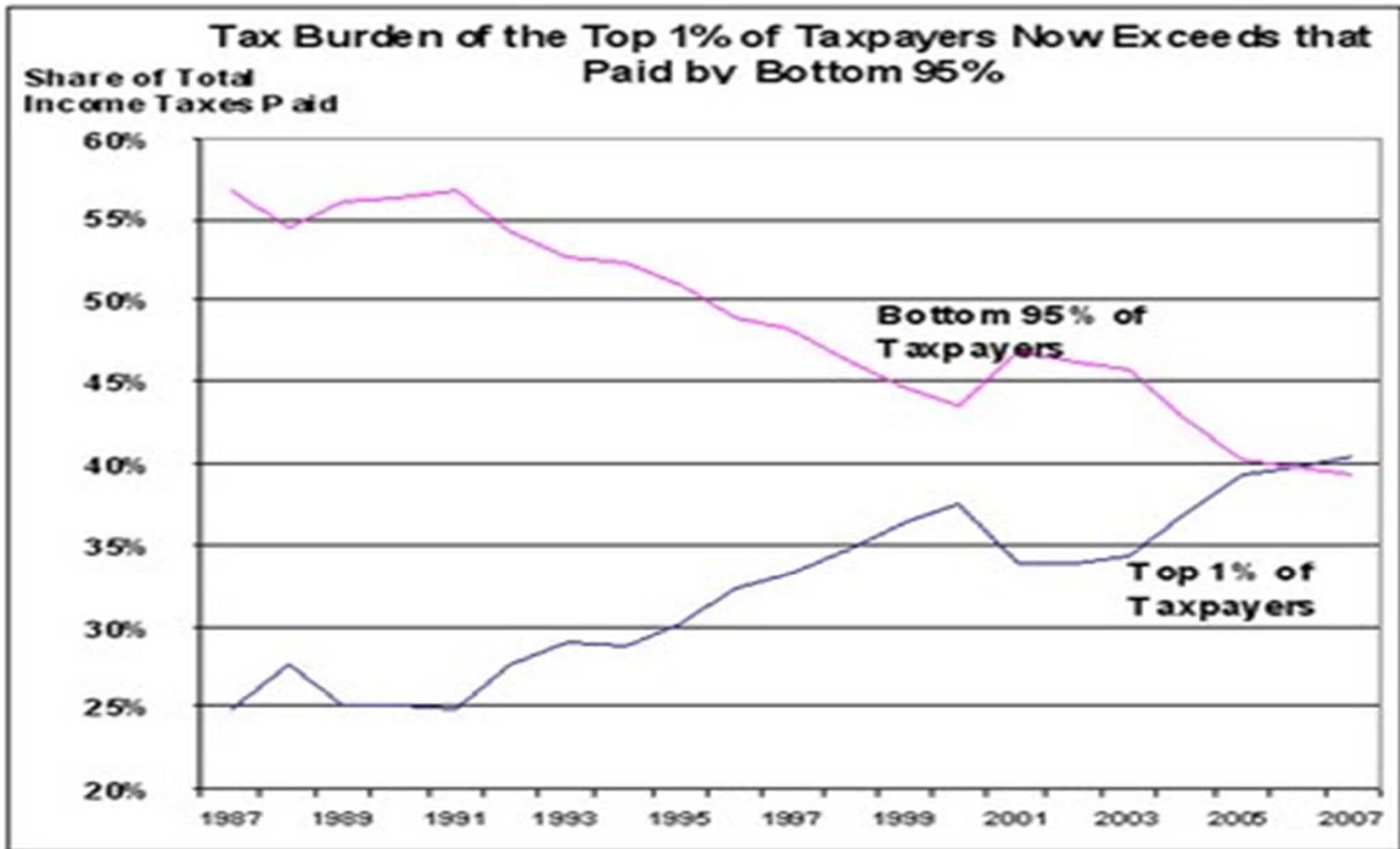
- Minimal funds for regulatory agencies; delayed appointment of officials

Dodd-Frank: "technical adjustments" proposed for Congress – creating loopholes for banks/shadow banking to leverage up

State legislators:  ALEC | American
Legislative
Exchange
Council

Diffuse voter restriction laws, anti-union laws, etc

It's My country: I PAY FOR IT



Meet the Lords of the New Economic Feudalism: Forbes March 2012, 1236 billionaires worldwide, 477 in US, just 46 in UK, 220 finance/investment

Rank	Name	Net Worth	Age	Source	Country of Citizenship
1	 Carlos Slim Helu & family	\$69 B	72	telecom	Mexico
2	 Bill Gates	\$61 B	56	Microsoft	United States
3	 Warren Buffett	\$44 B	81	Berkshire Hathaway	United States
4	 Bernard Arnault	\$41 B	63	LVMH	France
5	 Amancio Ortega	\$37.5 B	75	Zara	Spain
6	 Larry Ellison	\$36 B	67	Oracle	United States
7	 Eike Batista	\$30 B	55	mining, oil	Brazil
8	 Stefan Persson	\$26 B	64	H&M	Sweden
9	 Li Ka-shing	\$25.5 B	83	diversified	Hong Kong
10	 Karl Albrecht	\$25.4 B	92	Aldi	Germany

3.

HAZCHEM



Inequality beyond a certain level is dangerous to:

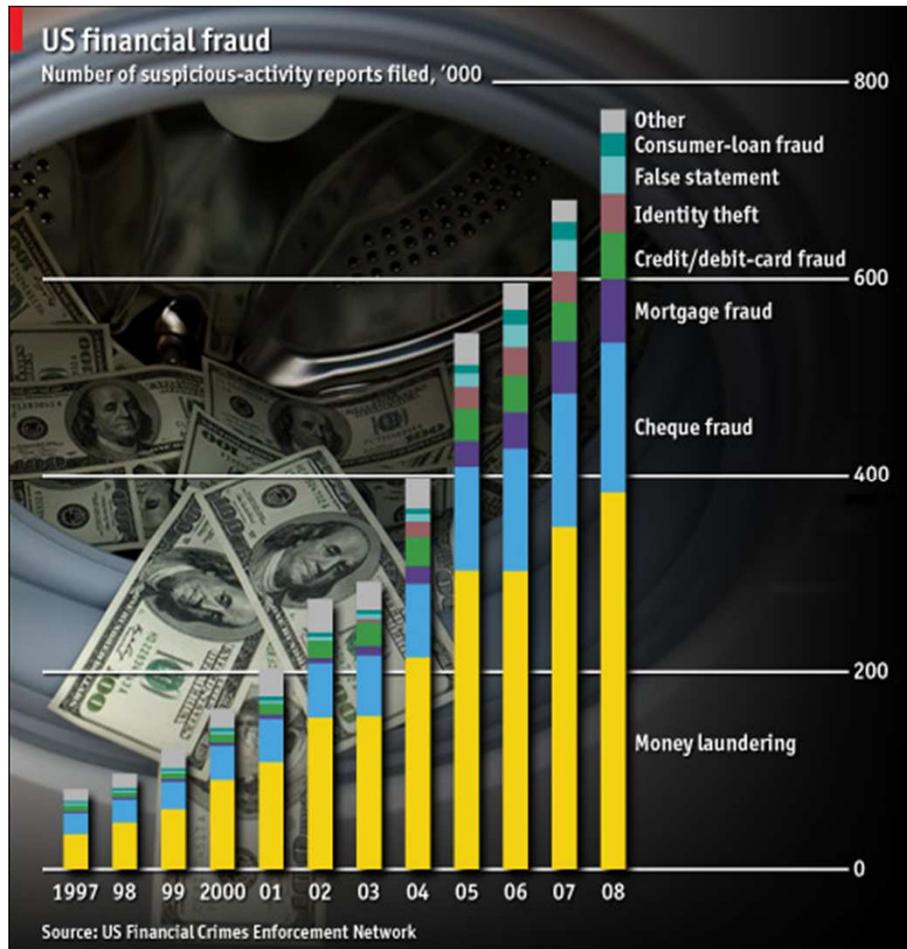
Economic health through incentives for financial crime, near-crime, and chicanery, risk-taking, rent-seeking.

Political health by empowering a financial moneyed elite to tilt policies to preserve or create greater inequality.

Intellectual health through incentives for researchers/thinkers to “toe the line”

Economic feudalism as an absorbing social state.

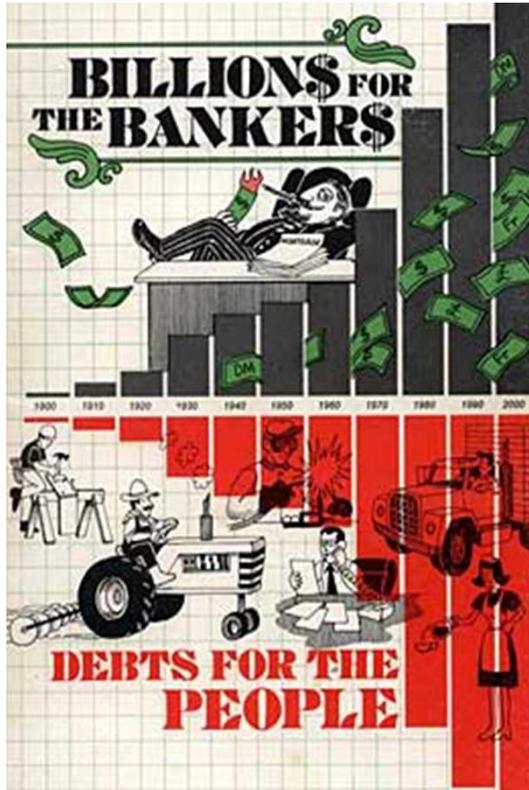
Financial crime, near-crime, and chicanery grow while “normal” crime rate plummets



Mortgage Fraud SARs	
Fiscal Year	SAR Submissions
2009	67,190
2008	63,713
2007	46,717
2006	35,617
2005	21,994
2004	17,127
2003	6,936
2002	5,609
2001	4,210
2000	3,245

2004 FBI warning “Mortgage fraud (is) becoming an 'epidemic'” which risks recreating the 1980s S&L crisis.

Austerity → Depression → Blackhole → ???



Some claim: Inequality → Individuals into debt → instability. But Sweden had financial disaster in early 1990s without much inequality.

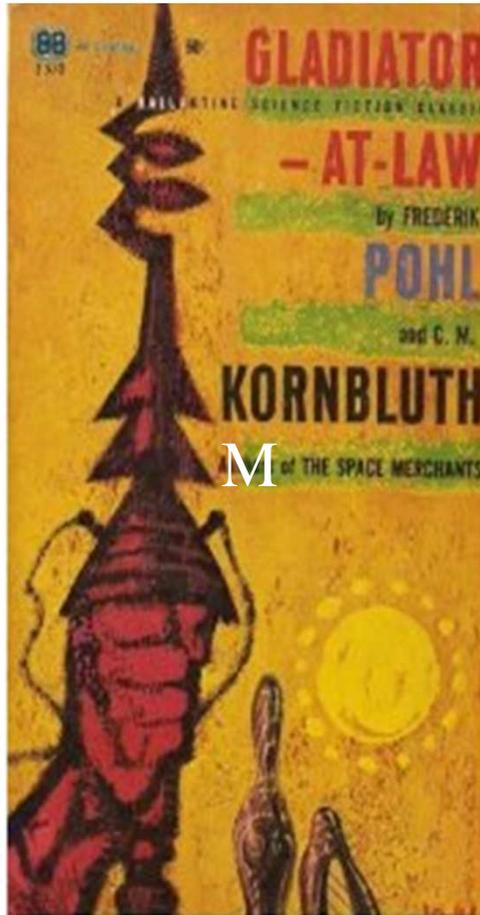


Who got it right?



Deregulation will “pave the way for a new round of record-shattering financial industry mergers, dangerously concentrating political and economic power, create too-big-to fail institutions that are someday likely to drain the public treasury as taxpayers bail out imperiled financial giants to protect the stability of the nation's banking system”
(Nov 9, 1999)

**“A frightful queerness has come into life”
HG Wells (1945): Swift's Struldbrigs**

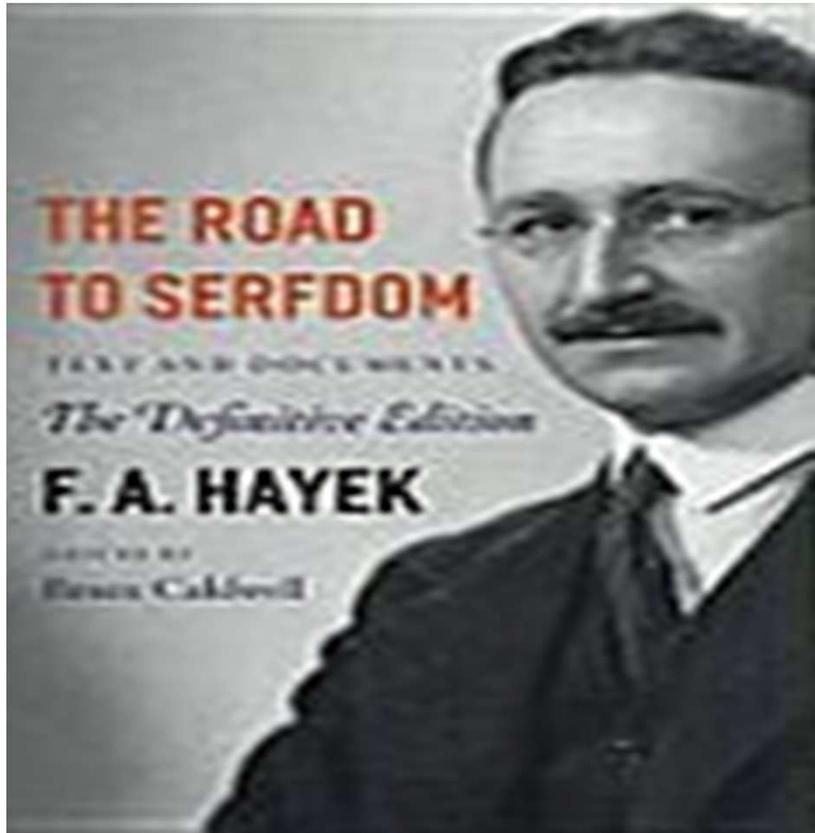


“We Fixed Mr.
Lincoln's Wagon,
Mr. Charlesworth”

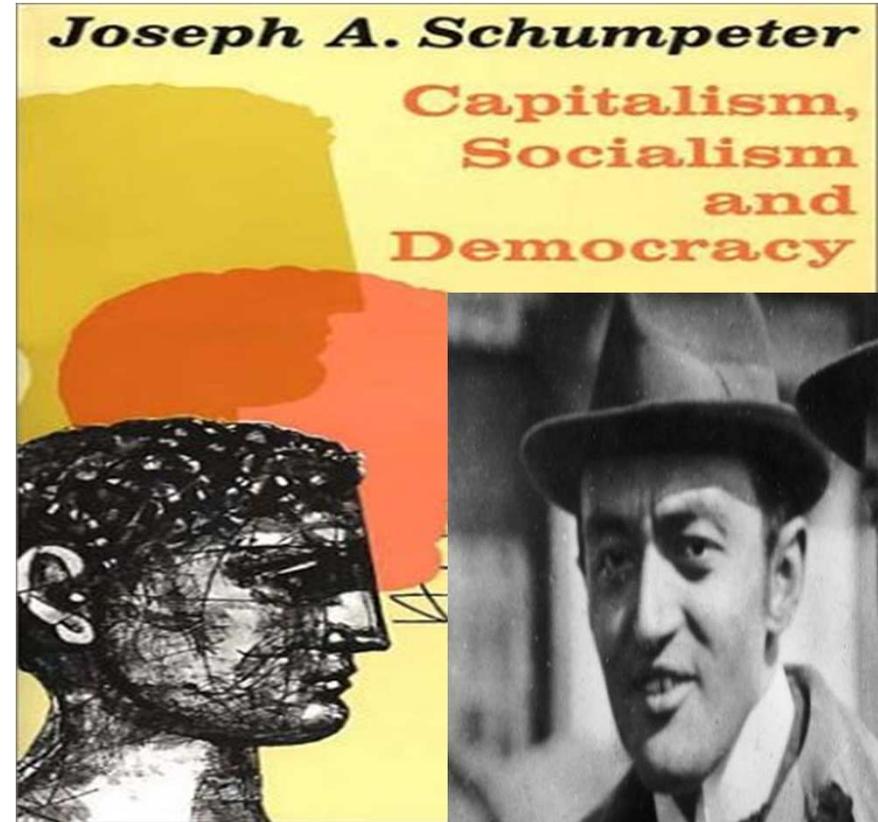
“We did, Mrs.
Green. And we will
Fix Her Wagon too.”



Economists who worry about the future of market democracy have focused on dangers from left



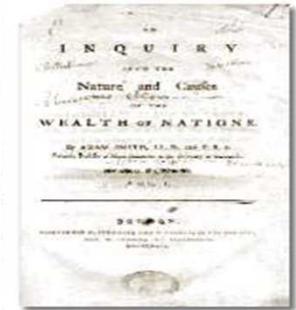
Serfdom? Serfs did not work for state, they worked for wealthy masters who controlled the state.



Written before Heritage, AEI, Cato, Inside Job ... as if "we" are not also economic creatures

Forgetting Adam Smith's warning (Wealth of Nations book 1, chapter 8)

“We rarely hear, it has been said, of the combinations of masters, though frequently of those of workers. But whoever imagines, upon this account, that masters rarely combine, is as ignorant of the world as of the subject.”



Crony capitalism a la Machiavelli:

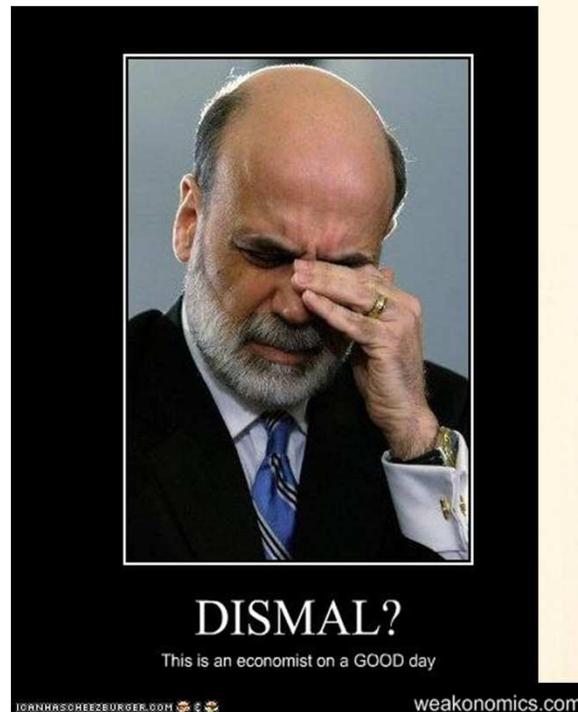
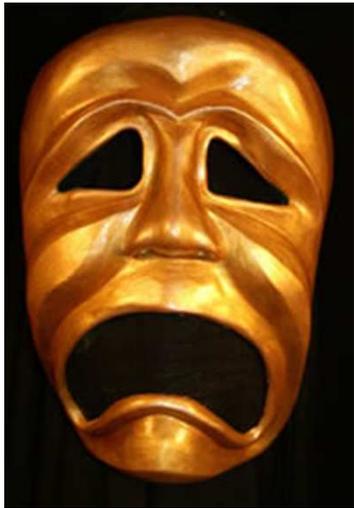
“He who has the gold gets to rule
He who rules gets the gold”

Why have economists ignored the possibility that “crony capitalism”/guanxi based on wealthy elite/politicians is an absorbing state?

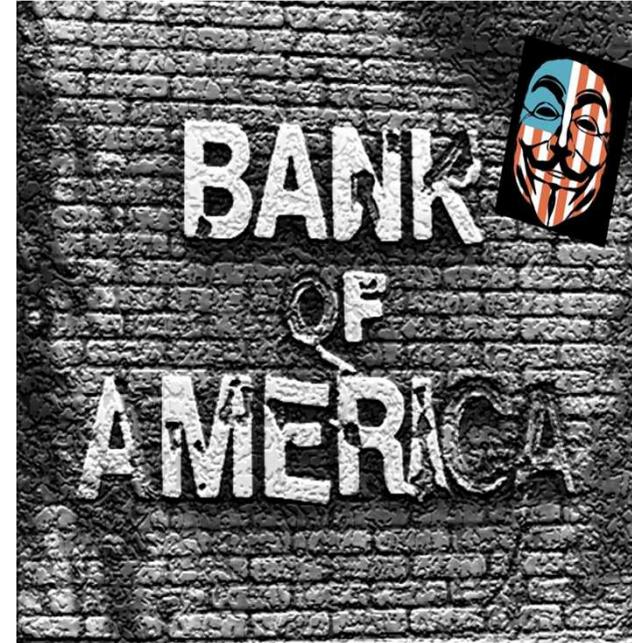
- 1- Absence of network models
- 2- Focus on market with fixed rules and free entry as opposed to way market makers set rule.
- 3- View government as exogenous representative of public interest.
- 4- Regard rent-seeking as relevant to developing countries or Russia, not advanced market democracies.
- 5- Rewards for supporting status quo in science without definitive experiments

4. Building Market Democracy Anew

Dismal science conclusion: economic feudalism based on crony capitalist capture of economy and government is endemic problem – a cancer on advanced countries rather than some developing country disease.



And yet...



And yet...



Citizens Science: crowd sourcing discovery



ZOONIVERSE
REAL SCIENCE ONLINE

Purpose

The Zooniverse is home to the internet's largest, most popular and most successful citizen science projects. Our current projects are here but plenty more are on the way. If you're new to the Zooniverse, we suggest picking a project and diving in - the same account will get you into all of our projects, and you can keep track of what you've contributed by watching 'My Zooniverse'.

GALAXY ZOO

HUBBLE

Welcome to Galaxy Zoo, where you can help astronomers explore the Universe

Galaxy Zoo: Hubble uses gorgeous imagery of hundreds of thousands of galaxies drawn from NASA's Hubble Space Telescope archive. To understand how these galaxies, and our own, formed we need your help to classify them according to their shapes — a task at which your brain is better than even the most advanced computer. If you're quick, you may even be the first person in history to see each of the galaxies you're asked to classify.

More than 250,000 people have taken part in Galaxy Zoo so far, producing a wealth of valuable data and sending telescopes on Earth and in space chasing after their discoveries. The images used in Galaxy Zoo: Hubble are more detailed and beautiful than ever, and will allow us to look deeper into the Universe than ever before. To begin exploring, click the 'How To Take Part' link above, or read [The Story So Far](#) to find out what Galaxy Zoo has achieved to date.

Social science/economics digital data/ transparency to fight economic feudalism

www.whitehouse.gov/open

<http://data.gov.uk>

www.opengovpartnership.org

<https://yeswescan.org/>

<http://opencorporates.com>

<http://sunlightfoundation.com>

<https://public.resource.org/>

<http://www.opensecrets.org/>



CARL

Carl Malamud



To endorse Carl Malamud for the office of Public Printer of the United States, comment on any blog post or, send your endorsement or any questions directly to Carl by email:

carl@media.org

or by twitter:

[@carlmalamud](https://twitter.com/carlmalamud)

Thank you for your support.

Solution: Data, crowd sourcing analysis, Internet
petition and information, off-line activities

Economics view: Creating a new market for
regulation/governance of markets based on
“invisible hand” principles to deal with
information, power asymmetry

Sociology view; Building and coordinating
new institutions based on new players



Will we get this done?



Before next financial/economic collapse?



Ralph Miliband Programme: the future of the left

Toward Economic Feudalism? Inequality, Financialisation, and Democracy

Professor Richard B Freeman

Herbert Ascherman Chair in Economics, Harvard University

Dr Robin Archer

Chair, LSE

LSE events

Suggested hashtag for Twitter users:
#lsefreeman

