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Two different sources of inequalities: profits *and* rents

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ABSTRACT

The starting point of our research was Piketty (2014) who stunningly conflates the concepts of profits and rents. Speaking of rent-seeking behaviour (as distinct from profit maximizing business investments), we use an entirely value-neutral and broader notion of rent than it was customary in the past 50 years of the literature. We return to the Ricardian tradition and define rent as payments for goods, services or for work in employment that exceed the competitive price.

In our paper two main propositions are presented: (i) rents are not anomalies in capitalist market economies, they are indispensable building blocks of it; (ii) rents are not the privilege of owners of capital or land. The income of those whose jobs are protected by unions or professional associations has a significant rent component too, and the same holds for top-managers or celebrities of the entertainment industry. Even state-generated monopolies are not necessarily evil, as they are often justified by other social objectives rather than social equity. For example, there are good and widely accepted reasons why intellectual property rights of pharmaceutical companies, individual innovators and artists are defended by "exclusion" in the Weberian sense through patents and copyrights.

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I. INTRODUCTION

While the question of inequality was a central theme to 19th century economics, in the 20th century the issues of inequality in incomes and wealth tended to be neglected. When it was brought back to the centre of attention, for instance by Simon Kuznets (1955), it was assumed that economic growth will automatically take care of it. During the past few years the topic received increasing attention, especially after the unconventionally voluminous, but nevertheless hugely successful book of Thomas Piketty, *Capital in the Twenty-First Century* (first published in French in August 2013).

On the bases of an extraordinary international data collection effort[1] Piketty believably claimed that the reduction of inequalities in the advanced capitalist countries during the six decades between 1910-1970 had been an exception. Since then capitalism has been gradually returning to higher levels of inequality of earlier times[2] and it is likely to become even more unequal, unless we find appropriate policy responses during the rest of the 21st century.[3]

Piketty's main finding and his main prediction were enthusiastically received by an influential part of the economic profession, the media, the wider public and many international organizations as *the* right answer to the dilemmas generated by the international financial crisis of 2007. Concurrently, in a flagship publication the OECD (2015) took an unambiguous position. Their experts claimed that income inequality had had a sizeable and statistically significant negative impact on the long-term growth in 19 core OECD countries between 1990 and 2010. The World Bank (2013) is focusing on the future; the aim of their ongoing Shared Prosperity Program is to condense extreme poverty[4] from the present 20 percent below 3 percent by 2030 at the world level through policies targeting the bottom 40 percent of the income scale in each and every country of the world.

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[1] The World Top Income Database, see http://topincomes.parisschoolofeconomics.eu/

[2] See in particular Figures 10.1 – 10.6 pertaining to wealth inequalities calculated for adults only in Piketty (2014) pp. 344-349.

[3] It is another, though not unimportant matter that the epoch between 1910-1970 was burdened with – *inter alia* – the Great Depression, two world wars and the Iron Curtain. Thus, there are no good reasons to wish the return of the social conditions of those decades.

[4] The proportion of people living on less than 1.25 international dollars, calculated at 2005 purchasing power parity.

Piketty's book was hastily translated not only into English, German, Spanish – i.e. the languages of the advanced Western economies -, but also into the national languages of 15 post-socialist countries, including Russian and Chinese.[5] If nothing else, this is a clear sign that inequality is a popular issue in this part of the world, too. Here, the rise of inequalities after the 1989/1990 regime change was even more spectacular than in the Western world. Sizeable assets have been accumulated in the hands of a few self-made billionaires already. On the 2015 Forbes ranking list of the world's top 100 billionaires, starting from the 29th position, the names of four Chinese and six Russian businessmen can be found.[6] Prior to 1989, there were no billionaires in the communist countries; names from these two countries appeared first on the list in 1997.

According to Piketty, inequalities are not only increasing, but capitalism becomes unequal in a different way: more and more wealth is inherited. The Western-type of capitalism becomes patrimonial capitalism. In a sense, capitalism is being re-feudalized in front of our eyes. In the post-communist context we do not have the data yet to test Piketty's assertion, but we can accept his point as a valid research question. We can only speculate about how much of the freshly accumulated post-socialist wealth is going to be transferred to the next generation. It is particularly unclear, whether the children of the present oligarchs in Russia and China will have the possibility to pass the entire set of property rights to their children – including the right to sell these assets to foreigners or move the family's financial wealth to foreign countries. But as far as rent-seeking behaviour as a source of private wealth is concerned, the post-socialist case, especially Russia and China are relevant examples for patrimonial capitalism.

Writing about the strengthening **patrimonial character of the advanced economies**, Piketty is essentially right, but for the wrong reasons. We agree with him that inequalities are growing and we share his view that this is a major threat to the legitimacy of the liberal order both at the national and the international level. At the same time, we are deeply sceptical about his central explanation, namely that excessive growth of profits[7] is the fundamental

[5] http://piketty.pse.ens.fr/fr/articles-de-presse/86 (Accessed 13 July, 2015).

[6] http://www.forbes.com/billionaires/list/3/#version:static (Accessed 6 June, 2015).

[7] In an unpublished paper – Mihalyi – Szelényi (2016) – we deal with the adjective „excessive". As it is well-known, Piketty's entire argumentation is based on his alleged discovery of r > g, where r is average growth of profits and g represents the average growth of GDP/head. We show that the $r > g$ model is a statistical artifact,

reason for inequalities which, in turn, slow growth and generate popular dissatisfaction in the long run. One of the controversial tendencies in Piketty's work is – as Acemoglu–Robinson (2014) and Atkinson (2015) point it out – that it tends to overemphasize the privileges of the top 0.1 – 1.0 per cent and their negative impact. This is problematic for two reasons: (i) the places in these elite groups are not long-lasting and not automatically hereditary[8]; (ii) the top 0.1 percent can influence the political process through voluntary donations disproportionately more than others, so it is important to look with scrutiny what happens to their life-long accumulated wealth at the end: whether it serves good or bad social objectives.

The purpose of our paper is to "bring rents back in", by and large neglected by mainstream economics.[9] In a way we turn from Smith and Marx to Ricardo for finding a theoretically sound explanation to the phenomenon of "abnormal" or "extra" profits - as the phenomenon it is often labelled today in the populist media.

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The rest of the paper is structured as follows. In Section II, we present something which is so obvious that people tend to overlook it, namely that much of our present inequalities are inherited from the pre-capitalist past and therefore cannot be explained by the general logic of capitalism. In Section III, we revisit Ricardo's theoretical legacy and make the distinction between two sources of inequality: one stemming from profit, the other from rent. In Section IV, we show that the Marxian concept of exploitation was based on the labour theory of value and Piketty was right, when he discarded this concept entirely. On the other hand, we show the way human and social capital plays a greater role in the intergenerational transfer of wealth and social positions as compared to the inheritance of profit-generating physical capital. In the fifth section we focus on the economic and social implication of rent-seeking behaviour and contrast it with profit-seeking. Finally, we conclude by stating that that rents are not anomalies in market economies. They are among the indispensable building blocks which need to be taken into account both in model building and policy making decisions.

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arising from the intermingling of the concept of profit and rent on the one hand, and capital and wealth on the other.

[8] See e.g. Stanley – Danko (1998).

[9] See Solow (2015) which bluntly acknowledges this.

II. OLD INEQUALITIES ARE STILL HERE

Before we dwell upon our interpretation of the sources of inequalities in modern capitalist societies, we make five clarifications pertaining to the past and current *levels* of inequality which we consider essential, but for the economy of space we cannot adequately discuss in this paper.

(i) Pre-capitalist societies were brutally unequal, but they functioned in ways different from the textbook ownership models of 19th and 20th century "classical" capitalism. Inequity, suppression and discrimination were based almost exclusively on social rank/estate or racial, ethnic, or caste divisions. All of these positions tended to be hereditary, or to put it differently based on ascription, rather than achievement. As societies transitioned into classical capitalism and inequalities emerged more and more on market positions, some of the pre-capitalist structures were carried over into the early phases of capitalism. The nobility – i.e. the landlords - enclosed the commons and turned themselves into capitalists. As a matter of fact, today one can still find unelected traditional rulers on the very top of the social ladder, such as the sheiks of the Gulf States, the kings and tribal leaders of many African countries owning the most valuable modern capital assets of their own countries.

Hence, unlike Piketty, we do not believe that the largest part of present day inequalities can be derived from "the fundamental laws of capitalism". Ethno-racial, religious discriminations are still *the* major drivers of relative poverty in large parts of the world. Consider the situation of African-Americans or Native-Americans in the US, the fate of aborigines in Australia, the misery of indigenous people in some Latin American countries, the suppression of Muslims by Hindus, Shiites by Sunnites (or *vice versa*) etc. In China, farmers still cannot freely trade the land they use or the houses they own; the *hukou* system still limits the right of hundreds of millions of people to join the urban middle-class. In East European countries, especially in Bulgaria, Hungary, Macedonia, Romania, Serbia and Slovakia, the Roma (gypsy) population is discriminated.[10] Other types of pre-capitalist social categorizations

[10] The exclusion of a significant percentage of this large Roma population explains a good part of the inequalities, as measured at the national level by the usual indicators (e.g. Gini-coefficient, absolute poverty). Under socialism Roma were also discriminated against, but at least their rate of employment was high. Unemployment exploded in this population by the last years of socialism and after the regime change. According to estimates made for 2012 by the Council of Europe, the share of Roma in the above mentioned six countries ranges from 7.5 to 9.9 per cent. The share of this minority in the population (and the very definition who are Roma) is hotly debated. In any case, it is generally accepted that up to half of this population is at the bottom of income hierarchy (some call it even to be an "underclass").

remain also highly consequential, like the caste of untouchables in India and Japan, or in Kazakhstan, where the entire population is "ranked" in three clans or *jüz* in Kazakh language.

Within-family inequalities need to be mentioned as well, such as the fate of "missing women" in many parts of Asia.[11] Furthermore, as Piketty (2014) himself acknowledges, the principle of primogeniture still exists in many parts of the world: the eldest son inherits all of the family property (or a disproportionally large share).[12]

(ii) In many rich countries, a significant part of the poor are first or second generation of immigrants.[13] This is – partly – the consequence of the Rodrik (2013) paradox: the bottom 10% of the richest countries earn three times more than the top 10% of the poorest countries. It is highly disputed what is the total effect of migration on global inequalities. The remittances are of great and increasing importance for many poor countries and contribute to the decreasing of cross-country inequalities. They are not negligible even in post-communist countries, for instance in Poland and in Hungary with moderate, but increasing outward migration.[14]

(iii) It is often left out from the narrative that globalization significantly decreased the inter-country inequalities due to the large population weight of China and India, as opposed to the relatively small weight of many very small, but very poor African countries. At the same time, rising international competitiveness of these large economies (as well as the successful post-communist member states of the European Union) have a depressing effect on the real wages of the median blue-collar factory workers in the older market economies. The rise of wages in the developing countries is the cause of the wage stagnation in the developed countries – these are the two sides of the same coin.

(iv) Low incomes arise from low minimum wages to a great extent. But minimum-wages, as a percentage of the median-wage vary significantly among the developed countries. In 2013, the legislated minimum wage amounted to 63 percent of the average wages of full-time

[11] See the seminal study of Sen (1992).

[12] *op. cit*. p. 362.

[13] In 2013, the foreign born population accounted for 13.2% of the total population in the US and 9.9% of the European Union. OECD (2015b) p. 17.

[14] Mihalyi (2014).

workers in France, but only 39 percent and 37 percent in the United Kingdom and the US, respectively.[15] In cross-country comparisons, there is a trade-off between higher wage inequality and the level of underemployment among low-skill persons. The problem is even more severe for those not in the regular workforce. In the grey or second economy, people can earn incomes from all kinds of *ad hoc* activities, and those incomes never appear in the statistics.

(v) While inequalities are obviously reflected in health outcomes at the society level, ill-health in itself is an independent source of inequity even in the most advanced countries. As a result of genetic heritage, a fatal accident or infection (e.g. AIDS) many people lose partly or fully their wage earning capabilities for a prolonged period of time, or forever. This and the uncompensated, above-average health expenditures are likely prohibit these people to accumulate wealth in line with their social peers. This has not much to do with political economy.

III. PROFITS VERSUS RENTS

In the descriptive analysis of our times, Piketty works with a *three-class statistical* model: the top 10 percent of wealth-owners constitute the upper class, the next 40 percent is the middle class and the bottom 50 percent is the lower class.[16] In his explanatory model, by contrast, he relies on the Marxian *two-class political economy model* and takes no full account of the special situation of the self-employed who generate their income from their own work and the assets they own.[17] In Volume I of *Capital*, Karl Marx already focused on profit-wage differentials. In an attempt to elucidate exploitation, Marx proposed a model with owners of capital, as an ever shrinking minority and growing number of wage labourers who only receive the costs of reproduction of their labour power.

[15] https://stats.oecd.org/Index.aspx?DataSetCode=MIN2AVE, accessed on 7 June, 2015.

[16] Tables 7.1. – 7.3.

[17] This is not a small omission. In 2013, the share of self-employed in the working population was 16.5% in the EU27 and 6.6% in the US. https://data.oecd.org/emp/self-employment-rate.htm, accessed on 9 July, 2015. For the possible complications arising from this, see Guerriero (2012) paper.

Piketty basically accepts Marx's theory, according to which there is an overarching, secular tendency for an infinite accumulation of capital, so capital is concentrated in fewer and fewer hands. It is important, and Piketty is fully aware of it, that the Marxian theory is based on the inherently inconsistent *labour theory value*. Marx wanted to show that property is not "theft" (Proudhon, 1840). He insisted that in all market exchanges equivalents are exchanged. It is not the personal greed of the capitalists that drives the process of exploitation and the extended capitalist reproduction process. The capitalists pay the full price of the labour power of the workers (hence the costs of reproduction of labour power) to those whom they employ, but they keep workers working beyond the hours necessary to cover these costs and they appropriate the surplus created during the extra hours of work. In a closed economy, under perfect competition among capitalists, the individual capitalist has no choice. He has to keep wages at the level of reproduction of the labour power and he needs the surplus (profit) to reinvest in order to remain competitive with other capitalists. Hence the low wages of the working class and the profit of the capitalists fit into an equilibrium model.

Under these circumstances capitalist expanded reproduction is a **positive-sum game**, and Marx also thought in that way, although he obviously didn't use this metaphor. If all profit has to be reinvested, more profit may mean more jobs (or what Marx in mid-19th century did *not* consider) higher wages for workers (to generate sufficient demand for capitalist production). John Roemer, arguably the most distinguished "rational choice neo-Marxist" correctly noted: "The *neo-classical model of the competitive economy is not a bad place for Marxists to start their study of idealized capitalism*".[18] While Piketty expressively rejects the Marxian theory of exploitation, he tends to concur with Marx's followers in the 20th century and assume that – apart from exceptional periods, when governments intervene into the economy with redistributive policies or when wars destroy the accumulated private wealth - wages remain relatively low all the time, while capital keeps increasing.

But why does the infinite tendency towards capital accumulation and increasing inequality matter, if the capitalists keep reinvesting the profit in the production process hence creating more jobs? If expanded reproduction is a positive-sum game, what's wrong with it? Marx

[18] Roemer, 1982, p. 196. Using another metaphor, this idealized capitalism is a win-win situation both for workers and capitalists alike.

offered a revolutionary answer to this question - which proved to be wrong historically, the theory of declining rate of profit.

MARX'S CONCEPT: THE DECLINING RATE OF PROFIT

Marx anticipated that the rate of profit/surplus value, $s:(c+v)$ tends to decline historically. Over time the organic composition of capital, hence $c:v$ will increase, the capitalist will have to invest more and more in constant capital (c), but if that is the case the capitalist has to increase the rate of exploitation $s:v$, but that could only lead to the absolute impoverishment of the proletariat and at one point has to culminate into a social revolution and abolishment of capitalism.[19] But as a prisoner of the labour theory of value, Marx could not consider the possibility that investment into constant capital can increase (occasionally tremendously) the national income of a country. In his closed model, which includes the reproduction of labour as well, productivity increase cannot yield an increase in value or surplus value. "*An increase in the quantity of use values is an increase of material wealth. With two coats two men can be clothed, with one coat only one man. (...) However then productive power may vary, the same labour, exercised during equal periods of time, always yields equal amounts of value*."[20]

Once we step out from Marx's model based on the labour theory of value, we cannot question that cheap technology, like computers can have massive productivity gains, and hence rise in national income, as well. This is the explanation why profits in the real world did not decline, the rate of exploitation did not grow, the revolution did not happen and instead the real incomes of workers have increased enormously since Marx's time.

David Ricardo ([1817], 2004), who lived two generations before Marx, was convinced that the concept of rent was indispensable to explain inequalities he observed. As it is well-known, he defined rent as scarcity **rent**[21]: an income derived from monopolistic ownership of agricultural land or mines. In his framework, rent seeking was interpreted as a **negative-sum game**. In a closed economy, this behaviour creates no new wealth; rather it reduces economic growth and reallocates incomes from the bottom to the top.[22] The importance to contrast profits and rents is not trivial whatsoever. Already Ricardo noted the absence of clarity in this distinction: (Rent) "*is often ... confounded with the interest and profit of capital*".[23] Ricardo made it clear that rent comes from the monopolistic ownership of land available in scarcity as distinct from the profit (or interest).

[19] See *Capital*, Vol. III, p. 250.

[20] As we can read this on the very first pages of Volume I. of *The Capital* (Ch. 1. Section 2.: The twofold character of the labor embodied in commodities.)

[21] In economic text books this is often called „economic rent".

[22] As he put it "The rise of rent is always the effect of the increasing wealth of the country, and of the difficulty of providing food for its augmented population. **It is a symptom, but it is never the cause of wealth**" (our emphasis). (*op. cit.* p. 40)

[23] Ricardo (1817), 2004, p. 34.

While Piketty is challenging the ethical bases of the observable income and wealth inequalities, he preserves the framework of the marginal productivity theory of income distribution developed by J.B. Clark (1899). Wages and profits reflect respectively the marginal product of labour and of capital. A person's income is determined by his contribution to production, or more precisely, by the marginal productivity of the "factor of production" to which he contributes. It is a truly **zero-sum game**. There is no "room" left for rents in the model, or it has to be assumed that rents are paid from profits at the end. This is exactly what Piketty presumes - following Marx, but without saying so.[24] According to him, Clark's theory is fundamentally right. When wage earners and capitalists fully share the annual national income between them, there is no injustice or exploitation. Both classes get what they deserve. There is only one exception in Piketty's line of argumentation: the compensation of the highest paid executives of multi-billion dollar corporations. He does note that these "supermanagers" receive more than they deserve, owing to their influence and power in the firm, where they are employed.

A. Changing and new forms of rents

Ricardo believed that agricultural land was despairingly scarce. Hence its supply is inelastic, while demand for food steadily grows. Under these circumstances the owners of scarce land receive **scarcity rent** without producing more or better food (one may say: without producing new value). Such rents channel resources away from productive investments and cuts in real incomes of wage and salary earners. Ricardo proved to be wrong, too. First, he did not consider how much the fertility of land can be increased. Secondly, and more importantly, the price/value of agricultural land declined after the inclusion of the Americas and Australia into the emerging capitalist world economy. In fact, there is even in the 21st century an abundant supply of uncultivated agricultural land around the globe.[25]

As we have already suggested in Section II, the early high levels of inequalities were driven by two other forces, and not the ones Marx and Piketty pinpointed. (i) In European countries (especially in England) the privileged estate was able to covert its feudal privileges into

[24] Piketty (2014) tends to conflate profit and rent and - as Weil (2014), Stiglitz (2015) and Atkinson (2015) pointed out critically among others - he deliberately disregards the differences between capital and wealth (*op. cit.* p. 47.).

[25] Under the FAO's definition, agricultural land covers only 33% of the world's land area.

privileged positions on the market; (ii) since appropriate mechanisms of market regulations were not in place, it was possible to create monopoly situations (this is what Marx deliberately excluded from his basic model[26]). In some well-noted cases, this type of monopoly was the source of the extraordinary wealth**.** John Rockefeller is a prime example who by 1900 controlled the production of crude oil, its refineries, transportation and retail sale; hence the price of oil (and his income/wealth) was not controlled by market competition. To reverse this state of affairs, it required Theodore Roosevelt's anti-trust regulations, which effectively put an end to his monopoly.

While socialist countries were believed to be highly egalitarian (that was certainly their legitimating ideology) and indeed inequalities measured in incomes were modest, but those with higher rank (high cadres) tended to be over-compensated by various fringe benefits. Hence inequalities under socialism in their logic resembled those of pre-capitalist societies.[27] Interestingly, the transition from socialism to capitalism was partly driven by the same type of forces. Former communist cadres turned themselves into capitalists in the absence of appropriate regulations of the markets. This was more so the case in Russia, Ukraine and other post-Soviet successor states than in Eastern Europe. In Russia today, the high concentration of privately owned wealth is based on the extremely high mark-ups applied in the natural resource sector (e.g. oil and gas). In other nations, wealth of local oligarch comes from other types of rent-seeking. In Vietnam, for example, foreign companies or individuals cannot have more than 49 percent of shares in any corporation.

But let's return to Ricardo's theory of scarcity rent. Pareto [1916] 1935)[28] and Sorensen (2000) already broadened Ricardo's notion of rent further to include all sorts of real estate and of all kinds of monopolies. Stiglitz (2012) also points out that while the scarcity rent does not really apply to agricultural land anymore; it certainly applies to **residential property** and other **real estate**. In some urban areas around the world from New York and San Francisco to Moscow, Shanghai and Singapore tremendous wealth was generated merely from the scarcity of highly desirable locations and not from productive labour or productive investment of capital. Today, the demand for housing no longer comes from just people who live in these cities all the time, but from the global wealthy who want to have houses in the above

[26] In Volume I. of *Capital,* Marx focused on profit and did not deal with the question of rent at all.

[27] Szelényi (1978).

[28] Pareto in his *The Mind and Society* made an interesting distinction between "speculators" (foxes) and "rentiers" (lions), hence between those who seek profits and those who seek rent. A balanced market capitalist economy needs both foxes and lions, dynamism and innovation has to be counterbalanced by stability.

mentioned globally attractive cities.[29] This private, consumption-oriented wealth becomes the property of a new urban "aristocracy", which passes this wealth down from generation to generation. Such wealth, reminiscent to the wealth of land ownership of privileged estates under feudalism is concentrated, indeed its concentration is especially high on the top 1 percent or even 0.1 percent of the social hierarchy. But there is a relatively large patrimonial upper-middle class, say the top 10-20 percent, which also benefits from all this.

But is it only land or real estate from which such rent can stem? When we speak of rent-seeking behaviour (as distinct from profit maximizing business investments), we use an entirely value-neutral and broader notion of rent than it was customary in the past 50 years of the literature.[30] Max Weber's concept of closure can be a useful way to conceptualize rent in such a broader way. Weber distinguishes "open" social relations (where participation is not denied to anyone who wishes to join) from "closed" relationships (where participation of certain persons are excluded, limited, or subjected to conditions).[31] According to Weber closed groups manage to monopolize advantages to their party, by occupying scarce and desirable positions, or by making desirable goods and services scarce through clientelistic practices, by creation of cartels or monopolies.[32] Today, scarcity rent is one of the explanations of the very high compensation packages offered to the best specialists.[33] Firms, as well as universities, hospitals, sport clubs, etc. compete with their peers for stars. They don't want to lose a legendary C.E.O., a professor or an athlete to their rivals. It would hurt their prestige and profits. So they pay more and more, especially in those countries where excessively progressive income taxes do not paralyze such incentives.

Our contribution to this debate is that we believe that it is justified to make a clear distinction between scarcity rent and **solidarity rent**.[34] E.g., membership in a trade union reduces wage differentials, and as it is often complained by employers. In collective bargaining unions prevent the use of wage incentives to pay more to the best workers, teachers or doctors at the advantage of those who underperform. Arguably the income of those whose jobs are

[29] We are grateful to Daniel Treisman for this observation.

[30] See e.g. Tullock (1967), Krueger (1974), Posner (1975), Buchanan *et al.* (1980) and Bhagwati (1982).

[31] This is very close to the concept of Acemoglu – Robinson (2012).

[32] See Weber (1920) (1978), pp.43-44.

[33] Solow (2014) calls this rent of supermanagers a „sort of adjunct to capital".

[34] In Stiglitz (2015) these two concepts are treated under a single – in our view misleading – heading: exploitation rent.

protected by unions or professional associations is composed by two factors: wages/salaries and rents. In developed democratic societies, one of the main functions of associations such as trade unions or professional organizations was to create conditions for rents. When the power of trade unions was on the rise, solidarity rent helped to reduce inequalities. However, in the context of the globalized world economy the weight of trade unions declined[35], and this in turn is likely to have contributed to the stagnation of real wages for low-skilled manual workers in the manufacturing sectors of many advanced economies, and the US in particular. Those who collect pension in a pay-as-you-go system also receive solidarity rent, people who are on social welfare, whose health insurance is paid by tax-payers contributions do the same (as distinct from those who are in a funded private pension scheme, or whose health care benefits are paid from private insurance policies). Ideally, fiscal transfers always work as mechanisms of solidarity rent – a **transfer from the rich to the poor**. Interestingly, even under socialism workers collected a rent on top of their wages: they had almost absolute job security. It was very difficult to lay off workers, even those who chronically underperformed, even if they showed up at work drunk. Hence their income was only partially remuneration for their work, some of the income they collected almost as "owners" of the collective firm.

Aage Sorensen (2000), whom we have already referred to, offered such a broad interpretation of rent: "*Rents are payments to assets that exceed the competitive price or the price sufficient to cover costs and therefore exceeding what is sufficient to bring about the employment of the asset. (...) The existence of rent depends on the ability of the owner of the asset to control the supply*".[36] Sorensen also pointed out that the association of rents with land is not required: "Rent will emerge on all productive assets that are in fixed supply and that actors need to maximize their wealth."[37] If we accept this framework, it follows that ownership of potentially rent producing assets, such as licenses, credentials, access to loans to start new businesses or be a self-employed is not restricted to capitalists. It should be borne in mind

[35] Between 1980 and 2013, average trade union density fell in the OECD countries from 33% to 17%. This decline is uniform across all member countries, with the notable exception of the Scandinavian countries and Iceland, where the average membership rate among employees didn't change much and remained well above 50%. https://stats.oecd.org/Index.aspx?DataSetCode=UN_DEN# accessed on July 10, 2015.

[36] *op. cit.* p. 1536.

[37] *op. cit*. p. 1537.

that some who do not own profit-generating capital still have the possibility to accumulate wealth in other forms, such as pensions.[38]

Now, we have arrived to the central thesis of our paper. Theoretically it is appropriate to call rent that income, which is the difference between what income would have been in "open relationship" by "closing" such relationships to certain individuals or categories of individuals. In simple algebraic form:

Income from closed relationship – income from open relationship = rent.

It may be difficult to empirically measure all types of rents, but their existence can be demonstrated through counterfactual reasoning. What would have been the income of a closed group, if its members would have been competing in open relationships?[39]

Rents can be temporary or enduring. An entrepreneur who invents new technology may collect rent for a while, but eventually his competition will invest into the same or a similar **technology** and this rent will disappear, the incomes of competing entrepreneurs will be set by the supply and demand mechanism. There are many spectacular examples of this: the success of the Windows operating system invented by Microsoft, the rise of the cell-phones which crushed the monopoly of copper-cable based telephone companies, or the shale revolution over the past decade which reshaped entirely the OPEC controlled traditional oil industry. Following Sorensen (and also Marshall (1920)), we can identify two enduring sources of rent. First, some of the monopoly rents enjoyed by entrepreneurs are created **naturally** since the costs of entering production may be prohibitive due to the increasing returns to scale (e.g. airlines, network industries) or they may be **created by governments**, by issuing concessions to open mines or licenses to run tobacco and liquor shops. Such privileges were especially important in post-communist societies where privatization was

[38] It is noteworthy that in The World Top Income Database consumer durables and unfunded defined benefit pensions are not taken into account.

[39] At first sight, the Weberian concept of „closed" and „open" relationships looks identical to the proposition in Acemoglu – Robinson (2012), who coined the terms „exclusive" and „inclusive" societies. But the two are not the same. The two American authors – as the title of their book emphasizes – analyse the growth process at the level of nations. Weber speaks of „closed" and „open" relationships *within* a given economy – and this is the right approach, if we analyse inequalities within a given country.

managed by governments. During post-communist transition such clientelistic exclusion of competition from the privatization process or from competition for public procurement projects has not been rare, especially not in Russia. During the Yeltsin years the Kremlin often manipulated auctions of public property to pass wealth on to loyal clients. Second, there are personal rents on **biological endowments**, such as genetic predispositions (e.g. special talent in popular sports or in arts) at the level of individuals, and resource endowments at the level of firms and countries exploiting mineral wealth[40] and other types of **geographical advantages** such as access to open sea, sunny beaches or snowy mountains, etc.

It is very important to underline that artificial or government-created monopolies are not necessarily evil, as they are often justified by other social objectives rather than social equity. For example, there are good and widely accepted reasons why intellectual property rights of pharmaceutical companies, individual innovators and artists are defended by "closure" in the Weberian sense through patents and copyrights. It is not surprising that Aghion *et al.* (2015) found positive and significant correlations between innovativeness in the US on the one hand, and top 1 percent income shares on the other. Similarly, it makes a great deal of sense to require state permission for firms to build nuclear power stations, or even simple two-story houses. It is also in the general interest that physicians have to acquire a special occupational license (e.g. a university diploma) before they can start treating sick people. Other types of regulations (e.g. land use by-laws in urban areas) can be assessed, if at all, on a case-by-case basis only.

B. Class reproduction through the accumulation of human and social capital

The **educational system** is an important terrain of closures, as defined by Max Weber. Given the high costs of education, especially of elite education, access to the most highly valued education may not be open to all, but it is closed to youth whose parent can afford the often prohibitive costs.

This is particularly prevalent in the US. At Ivy League universities youth from white upper-middle and upper class is overrepresented and it is reported that such class selection is getting

[40] OPEC is the most obvious example.

stronger over-time. One obvious mechanism is strictly achievement based entrance exams, where the children coming from more affluent families simply outperform those who arrive from average families. It is less obvious that the recent trend for US colleges to admit students not just on the basis of intelligence, but on the basis of being "well-rounded" (i.e. having taken ballet classes, performed in plays, founded clubs, volunteered time helping handicapped children, etc.) works in the same direction. Whereas there is some randomness in the distribution of intelligence, all these extra-curriculum activities are things that only very upper middle class, private school children can do.[41] The experience of the United States, in many ways the pace-setter of the capitalist economic system shows that family formation through **assortative mating** further strengthens these tendencies.[42] Since educated men tend to marry educated women more often than two generations ago, this inevitably leads to a concentration of income and wealth, which in turn helps these "privileged" parents to invest time and money in the future of their children literarily from the day of their birth. Children born in families, where both parents (and perhaps even grandparents) hold a university degree, are outcompeting their less fortunate peers throughout the education ladder and later on the job market. This is the main channel through which social inequalities are regenerated and hence patrimonial capitalism is taking more and more ground – not only for the top 1 percent, as Piketty suggests[43], but for the upper-middle class as well.

The reproduction of almost feudal privileges by the educational is becoming surprisingly strong is post-socialist societies, too. Access to tertiary education of underprivileged strata is much reduced and at least in some countries, like Hungary there is a trend to go back to early "tracking system", hence in the name of "labour market needs" put young people from poorer families on vocational tracks, to make the decision whether one wants to pursue a vocational of academic career as early as age of 14.

There is an additional mechanism of closure in the educational system and that is **credentialing**. Education is often conceptualized in terms of human capital investment. It is usually assumed that human capital invested into education will lead to productivity gains and higher incomes for the better educated results from such productivity gain. But especially powerful professional associations (such as American Medical Association, or American Law Boards) requiring bar examinations play a role to control the supply of occupations under

[41] The authors are grateful to Daniel Treisman for this observation.

[42] Greenwood *et al*. (2014).

[43] *op.cit.* 485-486.

their jurisdiction, hence they may drive up incomes for those occupations by adding a rent to their income from work.

The emphasis on credentialing (rather just on education or training) may have consequences on what kind of knowledge will be required from candidates seeking valued credentials. Not all knowledge required to pass critical exams will have productivity gains, it may be just knowledge which is useful to screen candidates for such credentials. This is what Bourdieu ((1970) 1977) called "cultural capital" as distinct from "human capital". Cultural capital serves more the purposes of the reproduction of the "patrimonial middle class", or "patrimonial upper class" rather than increasing the productivity of the graduate. For parents it may costs as much as $300,000-$400,000 just to get their children an Ivy League BA or BSc – but the descendants' Ivy League degree will pass on to them the status of "nobility". Employers will seek Ivy League graduate not necessarily since their technical skills are better, but because hiring such people will add to the prestige of their organization.

IV. CONSEQUENCES OF INEQUALITIES

We do not underestimate the importance of relative changes in profits and wages. As long as wages are on the rise, this is a positive-sum game nevertheless. Neoclassical equilibrium models were all based on this assumption, which was not far from reality until recently. Globalization, however, has changed the nature of the game. While profits have been rising in many sectors of the US, Germany and other big economies, real wages in the same sectors were stagnating as a consequence of – *inter alia* - outsourcing and the growing share of financial sector. Hence, we agree with Piketty that present day conditions, the wage-profit relationship can also become a negative-sum game for low-skilled workers and employees, which in turn fuels populist sentiments against globalization, migration and the highly educated, highly paid business executives. Having said this, we assert that the profit/wage inequality is only loosely related to economic growth or social stability. In some societies – in the United States for instance – high inequalities are accepted and the US produces relatively fast growth and social stability with GINI over 0.40. Some other societies (in Scandinavia for instance) do not tolerate inequality well, but they still can produce good growth rates and great social stability.

In contrast to Piketty's main line of argumentation, we contend that voters and political activists are chiefly concerned about *personal inequalities* of income around them, and much less about the concentration of economic wealth and power in the form of publicly traded shares or family-owned companies – i.e. the apposite wealth of capitalists in a class-based model. While it is true, that sensational formulations, such as "48 percent of the world wealth is owned by 1 percent of world's population"[44], can easily catch the attention of the media and through the media these numbers stuck in the memory of social scientists – including Piketty, who often quotes such data -, these "facts" are not mobilizing ordinary people. In other words, most people are agitated not because of the gap between capitalists and wage-earners, but rather because the large variation of employee-wages. Typical cases are, when the salaries of doctors, teachers or policemen are compared to the salaries of bank managers or widely-known celebrities in the area of sport or music, or minimum wages are compared to the minimal cost-of-living. This is one type of scarcity rents, as we explained above.

The current that can be seen as running counter to Piketty is that increasing levels of inequality do not necessarily lead to political instability. Important counter-examples can be observed both in Western and post-communist democracies and post-communist authoritarian regimes. The disprivileged poor are inclined to abstain from voting in elections. This holds for such divergent countries as the US or Hungary, and the political elites are fully aware of this. In a vote-maximizing strategy, pro-poor policies simply don't pay off. In authoritarian China, where elections are largely ceremonial, inequalities skyrocketed, but so far the popular response was mute. Since 1978 economic growth was phenomenal, the boats of hundreds of millions were lifted out of poverty with the rising tides, even though at very unequal speed. So people might have accepted more inequalities as long as their prospects for a better life seemed secure. Martin Whyte (2010) found that inequality was not a major concern for the ordinary Chinese. Russia had similar experiences during the first few years of the 21st century.

Furthermore, everyday experience, but also a solid piece of academic research also show that ordinary people have little idea about the true (i.e. statistically measured) size of inequalities in their own countries. Gimpelson – Treisman (2015) demonstrated on a variety of large,

[44] Oxfam (2015), the renown charity timed the publication of its fresh research for the opening of the Davos economic summit, and skillfully captured the headlines of many newspapers. Another sensational formulation of the same report was that "85 richest people on the planet have the same wealth as the poorest 50% (3.5 billion people)".

cross-national surveys that what people think they know was often wrong. It is particularly noteworthy in their study that in a list of 40 countries, the "least correctly informed" people are the citizens of 8 post-communist countries (Ukraine, Hungary, Croatia, Slovak Republic, Estonia, Poland, Slovenia and the Czech Republic); while on the top of the list we find two rich welfare states (Norway and Denmark).[45] Moreover, they showed that the *perceived level of inequality* – and not the actual level – correlates strongly with the ideologically motivated demand for redistribution and the reported conflicts between the rich and the poor.

What really annoys people – ordinary people and social scientists alike - is the knowledge or the presumption that the successful entrepreneurs and specially the most successful ones are dishonest and corrupt. With the same logic public opinion often resents the rising gap between the living standards of the middle class and that of the families of the highly educated strata and – within this – the class of managers employed in the business sector. In the North American media, during the recent financial crisis, "Main Street" represented the interests of everyday people and small business owners, in contrast with "Wall Street" (in the United States) or "Bay Street" (in Canada), symbolizing the interests of highly paid managers working for large banks and corporations. In Southern European countries, like Bulgaria, Romania or Greece, where rent seeking, managed by government is especially common, this can be seen as an important reason for political instability and the strikingly low trust in market economy as such. Under particular historical circumstances, rent-seeking may have devastating consequences to economic performance und brutally negative impact upon the society. Klebnikov (2000) compared the Russian oligarchs to the American Robber Barons of the late 19th century. They had lots in common. But, as Klebnikov pointed out, the Robber Barons produced something and contributed to economic growth in the US. The Russian oligarchs devastated the Russian economy during the 1990s. They did not produce much or anything, but deposited their incomes in Swiss banks and accumulated spectacular wealth in real estate in the Riviera, in London or in Florida, not speaking of their yachts and art-collections.

[45] The list was compiled from a questionnaire, where people were asked to choose the income distribution diagram with the Gini coefficient closest to the correct one for their country in 2009. On the top, 61% of the Norwegian respondents made the right choice concerning the distribution of post-tax-and-transfer incomes, while in Ukraine only 5 (!) per cent of the respondents were right.

As we have already shown on the example of Ricardo's failure to predict "scientifically" the rise of scarcity rent for agricultural land, it is inherently impossible to predict the future trends of other types of scarcity rents, too. The last 20 years of the former Soviet Union, and the first two decades of post-communist Russia exemplified that rents on oil- and gas extraction can vary enormously and with this the relative income position of the workers as well. The same explanation holds for the case of Norway and the UK, if compared to France of Italy.

The rent-based interpretation of the importance of the natural resource sector can be further generalized. As the Hungarian economist, János Kornai (2013) convincingly argued, in other sectors, such as manufacturing or services the markets are also oligopolistic which allows the most efficient firms to harness higher than average profits through arbitrarily large mark-ups, or using our terminology: exploiting a scarcity rent. In microeconomic terms, usually there are two interrelated factors behind this: pioneering technology[46] and economy of scale. While this generalization may sound idiosyncratic for many economists trained on equilibrium models, it is a common place in the management science literature to say that many important industries never have more than three significant competitors.[47] The same trend in the literature also claims that this industry structure finds equilibrium when the market shares of the three companies reach a ratio of approximately 4:2:1 – i.e. there is a significant market share difference even among the top firms.

V. CONCLUSIONS

Our main inference is that the crucial question is not the extent of measured inequality (income or wealth). Countries with GINI around 0.20 or 0.40 can equally be economically dynamic and socially cohesive. Beyond the still existing pre-capitalistic, ethno-racial, religious, gender-based pay gaps, etc. described in Section I, the key political economy question is what mechanism generates inequality in the business sector: profit-seeking or rent-

[46] This might be a temporary advantage, as we explained earlier.

[47] This finding was first demonstrated by the founder of the Boston Consulting Group, Bruce Henderson (1976) and then later re-confirmed empirically on a much larger data set by Reeves *et al.* (2012). Since then, successful companies, like General Motors and others live according to this maxim. If they cannot become Number One or Two in an industry, they get out from that market and reinvest their resources somewhere else.

seeking. The statistically measured changes in the distribution of wealth at the society level cannot be explained by the fluctuations of profits, as Piketty contends. Rents play an equally important role. Our second assertion is that rents are not anomalies in enlightened, liberal capitalist systems. To a large extent, they are unavoidable and indispensable, while at the same time they are potentially dangerous for the system's stability. Hence, our contribution to the current literature is the re-introduction of the Ricardian concept of rent in an entirely value-neutral manner.

Piketty's book suggests a gradual shift from progressive income tax[48] toward progressive wealth and inheritance taxes. Beyond a certain amount of relative wealth (defined in the context of a given country) our distinction between wealth emanating from profits or rents is not relevant, hence we support such reforms. For sure, the fact that the current tax rates are extremely low in the OECD countries allows a huge manoeuvring room for future change.[49]

Finally, when discussing inequalities, it is a mistake to focus on the wealth of the top 1 percent or 0.1 percent, as Piketty does, because the positions in these elite groups are not long-lasting and not necessarily hereditary. Through the combined effect of accumulated human and social capital, higher per capita incomes, inherited real estates and assortative mating, the yawning gap between the families of the top 20 percent and the rest of the society is much more upsetting. There is a great deal of irony in the fact, that readers and enthusiastic supporters of Piketty's book who likely belong to the "patrimonial upper class", the top 20 percent of their own countries everywhere, are so irritated by the wealth of the top 1 percent.

[48] Few supporters of the progressive income tax system know that this idea was first coined by Marx and Engels in the Communist Manifesto (1848).

[49] In 2012, the combined revenue from all kind of property and (net) wealth as a percentage of GDP was in the range of 0.3% (Estonia, Mexico) and 3.9% (UK). https://stats.oecd.org/Index.aspx?DataSetCode=REV accessed 9 July, 2015.

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