

CHAPTER EIGHT

Growth and Rents in the Financial System

...[A]s society grows, the disposition to continue previous social adjustments tends to lodge this collective power, as it arises, in hands of a portion of the community; and this unequal distribution of the wealth and power gained as society advances tends to produce greater inequality, since aggression grows by what it feeds upon, and the idea of justice is blurred by the habitual toleration of injustice.

— Henry George

Henry George argued strongly that progress, while raising productivity and improving technology, would tend to lead to rising inequality and increasing poverty. He based this largely on his contention that rents would absorb an increasing fraction of the surplus, squeezing out wages and profits. The claim that non-rental incomes must be squeezed is defective because it rests on unacceptable theories of the wage and interest—as we have seen. However, George's claim was also supported by his account of land speculation, where large-scale landlords reinvested their rents and acquired still more land, rents from which they also invested, acquiring still more, so that landholding became highly concentrated—more monopolized. There is a lesson here that needs to be explored in the context of today's financial markets.

Savings as they are placed in portfolios need to be examined more carefully. Investment, and other kinds of spending, will

determine the level of aggregate demand, and therefore of incomes; out of income there will be relatively reliable percentages saved, which are different for different social classes and categories of business. These savings ratios give us the level of savings out of money income, and thus liquid, and the funds saved will then be incorporated into portfolios. This process is often overlooked, but it has an important implication—namely, that some portfolios will expand faster than others, resulting in growing inequality.

The Influence of Liquid Capital on Wages and Salaries, the Role of the Financial Sector, and Why This Phenomenon Was Not Seen Before

Throughout most of the history of capitalism, pay for labor or work done was separate from and, *ceteris paribus*, varied inversely to the returns to capital. In other words, we had wages and salaries versus profits. Rich men (the rich have historically been men) owned firms and paid their top managers handsomely. Managers were still subordinates, and their pay depended on how well they pleased their employers. The distinction between owners and managers remained clear, until the time came when “ownership” became, for most investors, simply a matter of holding securities—shares and bonds. That is to say, “ownership” meant ownership of claims to income rather than command over labor and real resources. Once this became established, the nature of the hierarchy of pay and position changed, and the way to move up in that hierarchy changed too. When

owners ran their companies, pay and promotion depended on winning the good opinion of your superiors, through good work or through many other, often less admirable, channels. This is the way things still work for the bottom 80 percent—perhaps 90 percent—of the labor force. But a significant fraction of total income at the top, a fraction that seems to be increasing, can now take a different route.

First, they are in a position to influence the stock market, and in effect (to some extent) choose their “owners.” They may be able to arrange for investor groups to buy into the company on favorable terms, or to make favorable deals. Second, they own enough capital that they have the option of using it individually to improve their position at work—in simple ways, like taking the time and spending the money to improve their skills or get an advanced degree; or in more complex ways, like resigning and setting up their own competing company, taking some of the business with them. Or, they can join an investor group that buys into the company, or make deals with executives of rival businesses. Having capital will bring them contacts and public positions, along with recognition, attention, and respect (whether deserved or not). These connections and appreciations will help them in many ways, unpredictably.

Besides these individual benefits conferred by capital ownership, there is the social, collective aspect: owners of capital share a common interest in its general profitability, in seeing that it is not taxed too heavily, nor regulated too strictly. In short, they can benefit from helping one another. Notoriously, corporations find common cause in managing markets and suppressing

competition at times; holders of financial assets are, if anything, even more likely to join together to find ways to enhance their wealth. One way is to establish a common, very high, standard for pay at the topmost executive levels in the corporate world. Top pay rates and individual cases both are generally vetted for boards of directors by outside consultants. Both boards of directors and consultants are made up of wealth holders, and tend to be sympathetic to increases in executive compensation. Earlier, of course, paying very high salaries to top executives could be seen as throwing away shareholders' money; but since the 1980s, productivity has risen while working-class and middle-class pay has stagnated.³⁵ There is, therefore, a margin available: the top pay to executives will come out of the savings on the pay of the bottom 90 percent.

A Simple Model of Wealth Accumulation and Inequality (with Linear Coefficients)

Portfolios have further implications for saving and accumulation, assuming that the output-expenditure side of the economy continues to function smoothly at, or near, full employment. Investment is assumed to be strong, so that there is steady growth from period to period, as shown in the growth model earlier. Investment will be financed in one of the ways just discussed, so that portfolios will have to adjust.

“Capitalists”—holders of claims to income from financial

³⁵ In the 1960s top executive pay in the United States was about 30 times the average pay of production, nonsupervisory workers. Today, it is about 300 times that.

capital (stocks, bonds, options, securities, etc.) earn what we shall call "profit" income, P , by which we mean income from holdings of financial capital, including real estate and real estate securities. Note, however, that workers also save, and therefore have such capital income along with their principal income, wages, W . So capitalists save a large fraction of profit, P , and a large fraction of their high salaries, $sc(Pc + Wc)$, where sc is capitalists' propensity to save (assumed here, for simplicity, to be the same for both types of income). Workers save a much lower fraction of wages (sw) and of their much smaller profit income, $sw(Ww + Pw)$. Besides workers and capitalists, as here defined, there will be a class of nonowners—a precarious class, with zero or negative net worth, and no job security (if they are employed at all). Any increase in financial wealth will increase inequality with respect to this class.

We know that the capitalist class has substantially more financial capital, fK , per capita than the working class; moreover, for this argument, which is about inequality between classes, we will include the value of holdings of land, office buildings, and rental property in the capital of the capitalist class, and the corresponding rents will be included in capitalist earnings from wealth. Worker capital will include owner-occupied housing, and their incomes will be adjusted for imputed rents. There will be a large difference between capitalist wealth, so defined, and working-class wealth, a difference expressed by the parameter, a . Therefore, capitalist earnings from (its managerial) work will be proportionally higher per capita than the earnings from work

of the working class.³⁶ Further, if the capital of the capitalist class contains a larger fraction of rental securities and real estate than does the capital of the working class, then the capital of the capitalist will expand faster on its own, due to the rise in rents brought about by growth. This will tend to increase inequality by itself.

Let us set this last point aside for the moment. If the coefficients for the impact of wealth on earnings from work are the same, then *wages per unit of capital* will be the same for the two classes. This ratio will be w . Writing the equations with the subscripts c for capitalists, w for wage earners, L for labor (number of workers), and W for wage/salary income—remembering that a is the ratio between capitalist and working class per-capita wealth—we get:

$$f_c K_c / L_c = a f_w K_w / L_w, \text{ where } a > 1, \text{ and}$$

$$W_c / L_c = a W_w / L_w. \text{ Combining these, } a \text{ cancels, so}$$

$$W_c / f_c K_c = W_w / f_w K_w = w.$$

Now consider the implications for the growth of inequality. The respective incomes of the two classes are: $Y_c = P_c + W_c$ and $Y_w = P_w + W_w$. Both P and W depend on fK here, that is, on

³⁶ We could and should add that credit availability depends on wealth, so credit will be available to capitalists far more readily and far more cheaply than to workers. This will intensify all our conclusions, but we will not include this in order to keep it simple.

the respective holdings of wealth by the two classes. We are not concerned at the moment with the real economy; we assume it is working well and that aggregate demand is such that the level of employment is satisfactory, and that revenues are such that wages, profits, and rents can be paid. Our concern is with the effects of growth on the holding of wealth, and with the consequent influence of these changed holdings on distribution. Growth of the holdings of the respective classes will depend on their savings. (We assume savings—demand for securities—to be immediately turned into new holding of securities: there is no problem of adequate supply of securities. This might reflect issuance of securities for investment equal to savings, or it might reflect the issuing of securities by financial firms—what used to be called “pyramiding.”)

$$S_c = s_c(P_c + W_c), \text{ and } S_w = s_w(P_w + W_w)$$

Now divide both sides of the first equation by the capital of the capitalist class, and both sides of the second by the capital of the working class:

$$g_c = S_c/fK_c = s_c(P_c + W_c)/fK_c = s_c(r + w), \text{ and}$$

$$g_w = S_w/fK_w = s_w(P_w + W_w)/fK_w = s_w(r + w). \text{ Hence,}$$

$$g_c/g_w = s_c/s_w.$$

Based on the premises of this model, both profits and wages stand in fixed proportion to capital— r and w , respectively; therefore, the growth of capital holdings will raise profits and wages in proportion. Thus, the growth of capitalist income, Y_c , will be given by g_c , and the growth of working-class income, Y_w , will be given by g_w . Accordingly, Y_c will grow faster than Y_w . Inequality between capitalists and workers will, therefore, increase at the rate s_c/s_w . But we should remember that there is a large fraction of the population that has no net wealth at all, so any increase in financial wealth will increase inequality with regard to them. Both capitalists and workers will increase their wealth at their respective growth rates compared to this underclass, which has no wealth and does not save.

Finally, as mentioned above, if the capitalist class has a higher fraction of real estate securities among its holdings, its wealth will tend to rise relative to the wealth of the working class for that reason alone.

Toward a More Complete Model

Increases in inequality will tend to reduce the propensity to consume, weakening the multiplier and making it harder to sustain aggregate demand. They will also tend to shift investment and innovation toward luxuries and items for the extremely rich, such as the emerging field of space travel. The weakening of demand could make it more difficult to develop new products and new technologies that require enormous scale in production and need a mass market. This could bring on long-term stagnation,

leading to a collapse of investment, whereupon the effort to keep up the supply of securities, through pyramiding and developing derivatives, will affect the valuation ratio and could ultimately lead to another breakdown of the financial system.

On the other hand, a political solution could emerge—taxing unearned income, perhaps even taxing wealth (or, as Henry George advocated, taxing rental income), but most importantly, taxing financial earnings, at the same time providing a long-term stimulus to employment, including job retraining in the context of a system of public employment (preferably one that operates counter-cyclically, such as an Employer of Last Resort). These possibilities deserve careful attention, but they go beyond the objective here, which was to show how the saving-accumulation process, together with the effects of wealth on earned income, would tend, as George suggested, to generate greater, persistent, and increasing income inequality.