# Public Policy, Profits, and Populism

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## by Chris Brightman Jonathan Treussard Michael Aked of Research Affiliates

**Key Points**

- The recent decades-long public policy focus on economic stability has resulted in the unintended consequences of a profits bubble, collapse in securities yields, and wage stagnation.
- In response to labor's diminishing income share, a swell of populism suggests change is coming, and the form that change takes—reform or revolt—will either gently deflate or abruptly burst the profits bubble.
- A refocusing of policy priorities away from stability would facilitate the process of healthy creative destruction, aiding the formation of new businesses and jobs, and increasing the size of the economic pie.

Public policy prioritization of economic stability has coincided with slower new business formation, fewer and larger publically traded companies, increased monopoly pricing power, ballooning corporate profits, a sharp decline in the cost of capital, and stagnating wages. Refocusing policy away from inhibiting change and toward fostering growth through creative destruction would reduce bloated monopoly profits, raise wages, and increase yields on investment securities. Because highly organized special interests who profit handsomely from today's status quo stand in the way, implementation of such healthy reform may fail. A virulent populist reaction could dramatically increase the cost of capital and thereby raise the labor share, causing significant collateral damage.

**Reformer or Swamp Monster?**
"Lavish parties. Committee chairmanships for sale. Pay-to-play corruption. Backroom arm-twisting. Votes on major legislation going to the highest bidder. Welcome to Washington, D.C., the swamp that President Donald Trump was elected to drain." This is the Amazon blurb touting the book *Drain the Swamp* by Republican Congressman Ken Buck, who portrays President Trump as an independent Republican reformer in the mold of Teddy Roosevelt.

Dana Milbank writes in the *Washington Post* (April 17, 2017):

Last year, Mark Meckler, one of the founders of the tea party movement, had concerns about Donald Trump but gave the Republican nominee the benefit of the doubt, because Trump "at least says he's going to attack" the crony-capitalist system. Now the conservative activist has revised his opinion. Trump "said he was going to D.C. to drain the swamp," Meckler said in a recent Fox Business interview, but "now it looks like we've got the Creature from the Black Lagoon in the White House." For everybody else who believed Trump's populist talk about tackling a rigged system, it's time to recognize you've been had. The president of the United States is a swamp monster.

The Trump bump shows that the US stock market assesses the President as more swamp monster than reformer. Stock prices are hitting record highs and corporate profits are projected to grow briskly because the market anticipates a tightening of the grip of crony capitalists. In contrast, draining the swamp would mean pairing back the monopoly and pricing power of the entrenched and politically connected interests that impede creative destruction and economic dynamism.

To better understand the stock market's reaction to the populist wave that propelled Trump into office, we pose a couple of questions: Why has the share of income granted to workers been shrinking while corporate profits have soared? What policies might reverse this trend? Exploring these questions offers lessons not just to policy makers, voters, and workers, but also to savers and investors.

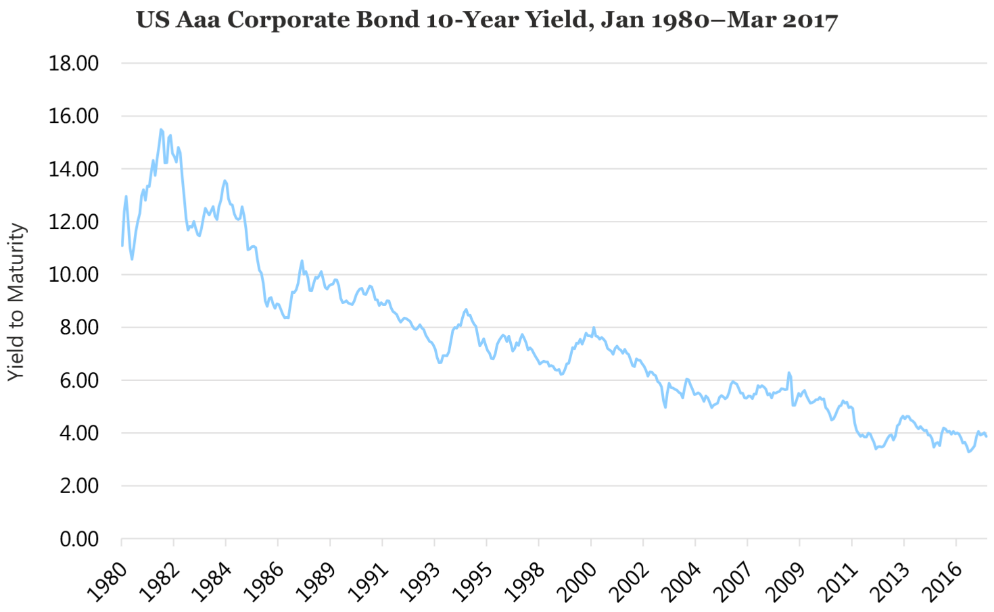
**Stability Lowers the Cost of Capital**
William Petty and Simon Kuznets began measuring economic value creation during the Great Depression, and in 1934, at the US Senate's request, Kuznets published "National Income, 1929–1932." He received a Nobel Prize for his work in 1971 at about the same time that gross domestic

product (GDP), the modern incarnation of national income, became central to public policy. Roughly 30 years later in 1999, Paul Samuelson heralded GDP as “truly among the great inventions of the twentieth century” (BEA, 2000).

Why policy became focused on preventing volatility of GDP is easy to comprehend. The history of the twentieth century records serial bank runs, depressions, and two devastating world wars. Modern macroeconomic management, with its toolbox of fiat money, countercyclical fiscal and monetary policies, and large and powerful regulatory agencies, seemed to offer the solution to deadly instability. In 1965, *Time* magazine quoted Milton Friedman as saying “We are all Keynesians now,”[1] thus announcing the neo-Keynesian policy consensus in favor of taming the business cycle.

Following the stagflation of the 1970s and the deep recession of the early 1980s, modern macroeconomic management succeeded spectacularly in lowering the risk faced by capital market participants. The cost of capital has duly and dramatically declined.

Over the last few decades, falling bond yields have followed on price stability and lower economic volatility.




Source: Source: Research Affiliates, LLC, using data from FRED at the Federal Reserve Bank of St. Louis.



Price stability and lower economic volatility have taught us to require lower compensation for bearing less economic risk. Lower risk premiums means higher capital market prices and lower yields on investment securities.

Soaring stock prices and growing profits obviously benefit those who already own capital assets—the wealthy. So, despite central banker protestations to the contrary, appreciation of capital assets also exacerbates the wealth effect, our real consumption response to financial shocks. Now, any decline in lofty valuations causes us—even the middle class, with less skin in the game—to feel poorer, thereby incentivizing us to curtail spending and investing.

We’ve experienced this wealth effect of asset market shocks spilling into the real economy not once, but twice, since the turn of the century. Increased sensitivity of the economy to changes in stock and housing prices has, in turn, fed into heightened demand for policy makers to act as stabilizers, justifying evermore radical macroeconomic management in pursuit of stability.

Policy makers have responded. We’ve recently experienced bank and corporate bailouts, negative real interest rates, quantitative easing, and soon-to-come quantitative tightening. Stock market indices record new highs, while implied volatility, risk premiums, dividend yields, and interest rates set new lows.

Consider the impact on those without much financial wealth. Towering capital market prices create a nearly insurmountable hurdle for those without financial means to accumulate the capital necessary to start a business, buy a house, and meet retirement goals. No surprise then that new business formation has plummeted, the rate of home ownership has dropped sharply for young adults, and retirement saving has become a luxury.

**Who Gets What Slice?**

Not long after economists began measuring economic output, they began studying its sources. Starting with Solow (1956), economic output was decomposed into capital and labor. Data prior to the late 1980s seemed to support this approach; capital and labor neatly accounted for practically all output. Residual "economic rent" or "profits"[2] was insignificant. For instance, Rotemberg and Woodford (1995) and Basu and Fernald (1997) found that profits composed less than three percentage points of the economy from 1959 to 1989. Emboldened by the obvious competitiveness of the market economy and lured by the simplicity of this assumption, researchers bundled everything not paid to labor as compensation to capital.

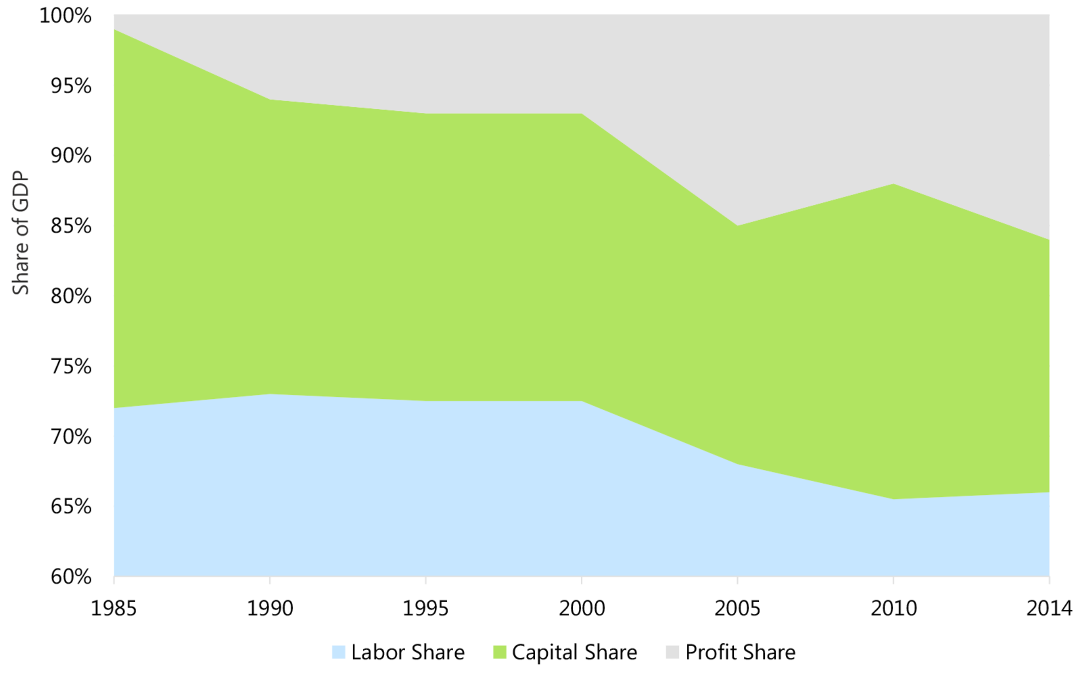
The pronounced decline in the share of economic output provided to labor over recent decades has been the subject of healthy and productive economic and political debate. Credible and well-researched explanations include technological innovations in manufacturing, decline in labor's bargaining power, expansion of international trade, and increased "financialization" of the economy.

Such explanations don't conveniently fit into traditional economic models. In the standard models, capital and labor are gross substitutable goods. If the price of capital falls relative to labor, we substitute more capital for labor, and the share to labor falls while the share to capital rises. Surprisingly, and contrary to the standard model, the share to capital hasn't risen as the share to labor has fallen. Over the last 30 years, we have seen large and concurrent decreases in labor *and* capital shares.

To understand this conundrum, several researchers have begun to question the zero-profit assumption. Barkai (2016) has undertaken the painstaking task of measuring profit separate from the capital share of the US economy, with remarkable findings. Profits (in the economic definition of extraction of rents over and above the public market cost of capital) have risen from insignificant single digits in the late 1980s to a startling level of 15% in 2014.[3]

Maintaining the level of production while lowering both labor and capital costs has inflated a profits bubble.

**Decomposition of Value Added in US GDP, 1985–2014**




Source: Research Affiliates, LLC, based on data from Barkai (Forthcoming 2017).



Autor et al. (2017) find corroborating evidence of growth in the extraction of monopoly rents, showing higher levels of firm concentration across multiple US industries and a “winner takes most”[4] concentration of profits. Maintaining overall production (GDP) while lowering both labor and capital costs has inflated a *profits bubble*.

These ballooning profits are not paid to savers and pensioners in the form of higher bond coupons and stock dividends: declining payments to securities holders are the opposite side of the ledger to the falling cost of capital over the last three decades. Those reaping the rewards of today’s profits bubble are more likely those who started businesses decades ago, and their heirs who are selling vastly appreciated ownership positions, and corporate executives paid through stock options.

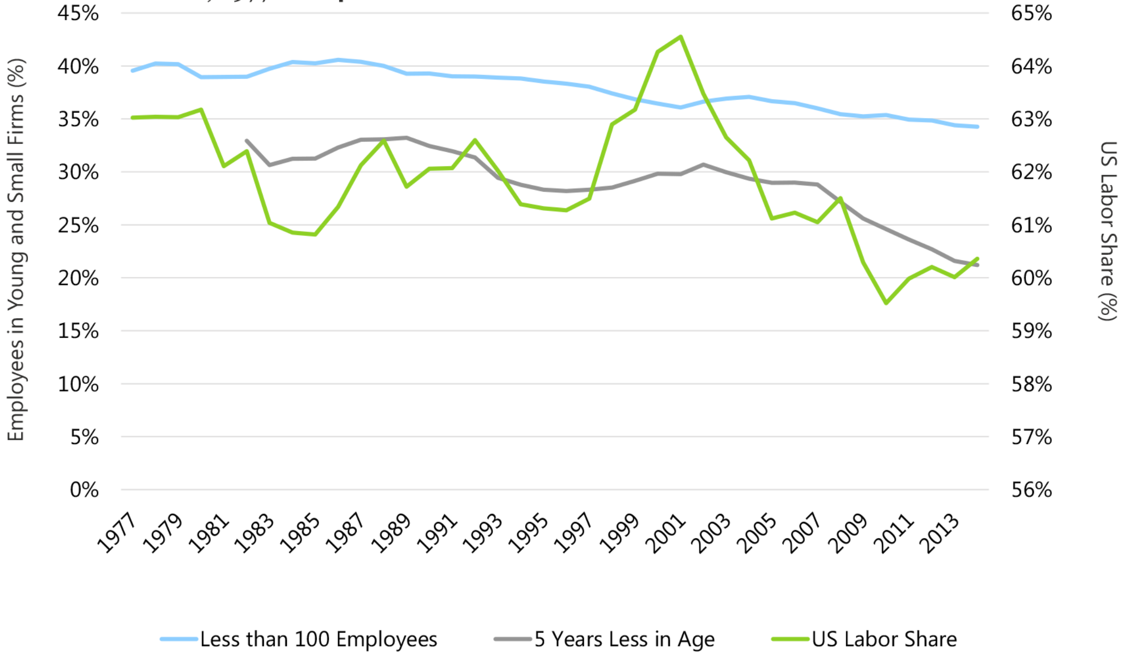
**Unintended Consequences of Stability**

The corridors of power sometimes seem to hold a near-monopoly on unintended consequences. Policy makers assume that all should benefit if they can successfully quell the volatile spirit of capitalism without losing the essence of a market-based economy. They fail to consider that, when taken to the extreme, lower macroeconomic risk hampers healthy creative destruction, unduly benefiting incumbent firms, and preventing new business formation. Bad management, bad products, and bad strategies must clear the way for those with better ideas to have an opportunity to succeed. In time, the employees of the former will find work with the latter, though the process is messy.

Importantly, the floundering incumbent firms are not creating new jobs. Investigating recent census data, Decker et al. (2014) find that, over the last 30 years, business startups contributed over 20%, and high-growth firms over 50%, respectively, of new jobs. Worryingly, the share of employment by such young firms fell by nearly 30% over the same period. Our research findings exhibit similar trends.

The recent period of low macroeconomic risk has hindered new business formation and job creation.

**Percentage of Employees in Young and Small Firms, and US Labor Share, 1977–2014**




Source: Research Affiliates, LLC, using data from FactSet and CRSP/Compustat.



Policy makers have too long assumed that the question of what size slices we provide to labor, capital, and profits shouldn't much matter and might even take care of itself. This convenient assumption ignores the political reality that slices are consumed by social groups with vested interests and a sense of relative fairness. Groups whose real purchasing power declines or merely doesn't rise in satisfactory terms *relative to others* sense a breach in fairness. Social dysfunction follows. To appreciate the severity of the consequences of such a breach of social equity, consider the widely reported increase in midlife mortality among the working class in the United States from alcoholism, opioid abuse, and suicide (Deaton and Case, 2017).

In Henry Hazlitt's astonishing book *Economics in One Lesson*, he builds on Frédéric Bastiat's pioneering work on the seen and the unseen. We *see* the jobs destroyed by creative destruction as failing businesses are allowed to fail. We *do not see* the legions of jobs never created and the brilliant products never offered by the countless startups never launched because these zombie firms are propped up for countless years.

**Alternative Future Paths**

Distribution of economic wealth between labor, capital, and profit is a societal choice. Whereas the future evolution of our economy and financial markets could take many paths, we outline here some more and some less healthy possibilities.

As a base case, our policies that prioritize stability, inflated capital market prices, and bloated monopoly profits over the last three decades could continue over the coming decades. This path leads to ever fewer and larger public companies and an even lower rate of new business formation. This path also implies a substantially lower fraction of output provided to both savers and workers, declining labor force participation, and growing social dysfunction.

To return to more healthy labor, capital, and profit shares while continuing to grow the economic pie may require progressive reforms, such as those championed by Teddy Roosevelt at the end of the nineteenth century. The specifics of such reform should be the subject of healthy political debate. Are today's winner-take-most corporations in possession of asymmetric information that justifies a twenty-first century anti-trust initiative? Would replacing employment taxes with a VAT increase after-tax wages and labor force participation? Could further tax reform favoring savings and investment over consumption and debt boost labor productivity? Are the returns to new public infrastructure above the cost of capital needed to build it?

While such questions should be the subject of a healthy political debate and the resulting policies the bedrock of a healthy economy, vested interests vigorously protect the status quo. Even successful reforms may require many years to fully realize intended benefits. Our present political culture may not possess the attention span and time horizon to enact such reform.

What might be done to address more quickly the shrinking share of income granted to workers and savers? An expedient approach would be to weaken current institutions through populist revolt. A populist capture of the reins of power followed by command-and-control redistribution to the newly empowered would likely quickly introduce uncertainty, inflation, and a rising cost of capital. Capital market prices would crash, perhaps producing more-equal slices of an almost certainly smaller pie. This is the road to Venezuela.

**Will the Profits Bubble Pop?**

Our public policy over recent decades has pursued stability above all. The unintended consequences of pursuing stability by inhibiting change include a profits bubble, collapse of the yield on securities, and stagnating wages. Today’s elevated stock prices assume continuation of these trends. In opposition is an increasing fervor of populist sentiment demanding change. If this change is toward healthy reform, then stock prices may gently decline in anticipation of a gradual deflation of the current profits bubble. If policy turns even more populist, then risk premiums and inflation may soar while stock prices crash.