A Competitive Approach to Inclusive Growth

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Since emerging from the depths of the Great Recession, the U.S. economy has seen a remarkable recovery. But it is important not to lose sight of the longer-term structural challenges that have been with us for decades. One of our most stubborn structural challenges remains the increase in inequality. Over the past few decades, inequality has been higher and has risen more quickly in the United States than in any of our peer economies.

In part, income inequality has risen as a natural consequence of competitive markets. Technology has increased the returns to greater skills among workers, but the rise in educational attainment has not kept up. As a result, increased income inequality in part reflects increased differences in the productivity of different workers. There are many traditional policy solutions to help blunt this trend: greater support for education; tax credits that aid low-income families while boosting labor force participation; and policies that make it easier to balance family and work, for example. These measures can increase the likelihood that individuals work today (for example, expanding the earned income tax credit for workers without qualifying children) or increase upward mobility and incomes for future generations (for example, anti-poverty and early education programs for children). Such policies are key to making competitive markets work well for all Americans.

But at the same time, a growing body of evidence suggests that much of the rise in inequality stems from cases in which markets fail to be competitive. When barriers to competition — such as monopolies or preferential government regulations — prevent new entry into markets, incumbents can collect more income than their productivity justifies. Economists call this extra income "economic rents," and evidence suggests that the generation of rents and their increasingly unequal distribution have contributed to the recent rise in inequality. As more economic rents are captured by a select few investors and high-income earners, inequality worsens, but productivity does not grow — the opposite of inclusive growth.

This area offers several clear opportunities for policies that can reduce inequality in an efficient manner by promoting competition and flexibility:

The first is monopoly profits. In recent decades, most industries have seen a trend of increasing concentration as the largest firms absorb more market share, reducing overall competition. Increased concentration may play a role in the strikingly large and growing disparity in profits across corporations, as well as the reduction in the entry of new firms and the commensurate increase in the share of larger, older, incumbent firms.

Second, the financialization of the economy may reflect some element of rent-seeking behavior. The share of national income attributable to the financial sector surged in the decades before the financial crisis, with some economists arguing that economic rents — as opposed to the creation of economic value — explain much of the rise. While post-crisis factors, including the Dodd-Frank Wall Street reform legislation, have diminished the role of financial firms, the financial sector's share of national income remains above historical trends. This is one of the reasons behind a range of proposals, including closing loopholes — such as the carried interest loophole — that help financial firms and their managers avoid paying taxes, and levying a financial fee on the largest financial firms.

Third, intellectual property regimes need to be appropriately balanced between rewarding innovation and fostering competition. Our current patent system intentionally creates rents to encourage innovation, but we must ensure that those benefits are worth the costs they impose on competition.

Fourth, poorly designed occupational licensing regimes can create economic rents by restricting new entrants in certain professions. The percentage of occupations requiring a state license in the U.S. has grown from 5 percent in the 1950s to 25 percent today, with licensing laws today covering not only fields like medicine and law but also occupations such as interior designer and florist.

Finally, excessive land-use regulation can create rents for incumbent landowners without boosting productivity. Of course, well-designed licensing requirements and zoning rules can also have offsetting societal benefits. Nevertheless, evidence suggests that when poorly designed or inappropriately implemented, land-use regulations tend to reduce economic efficiency and exacerbate inequality.

Some rents are desirable as spurs to innovation. Some rents are inevitable. For example, the matching process in labor markets inevitably creates rents. In these cases it is important where possible for public policy to shape the divisions of these rents, for example, by raising the minimum wage and expanding worker voice — including through an increased role for labor unions.

Public policy at all levels of government has a role to play both in helping Americans at all income levels succeed by giving workers the tools to succeed in competitive markets, and by promoting efficiency-increasing competition.

OPPORTUNITIES FOR INCLUSIVE GROWTH

1

Promoting competition by fighting market concentration

2

Addressing the financialization of the economy

3

Appropriately balancing intellectual property regimes

4

Reforming unnecessary occupational licensing

5

Curbing excessive land-use regulation