Inequality and Market Failure*

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Abstract

We argue that market failure is a major and growing source of income inequality in the United States and in liberal market economies (LMEs) more generally. This market failure takes the form of occupational, educational, managerial, and capital rents that are generated by institutional barriers that restrict the free flow of capital or labor. We suggest that these four forms of rent can partly account for (a) the extreme income inequality at the very top of the LME income distribution, as well as (b) the extreme income inequality that’s also observed *beneath* the highest percentiles of the income distribution. The sharp increase in these forms of rent, when coupled with rent destruction at the bottom of the labor market, may well explain much of the takeoff in LME inequality in the last four decades. We conclude by outlining the empirical research agenda and policy prescription implied by a rent-based account.
Inequality and Market Failure

The dramatic takeoff in income inequality in the United States and many other rich countries has generated one of the most active research literatures in the social sciences. We now have an extensive body of research on why the takeoff in inequality occurred (e.g., Goldin and Katz, 2008), who benefitted most from it (e.g., Salverda et al., 2009; Atkinson et al., 2010), and which countries experienced it in especially extreme form (e.g., Gottschalk and Smeeding, 2000; Salverda et al., 2009). The literature within economics on the causes of the takeoff tends to feature market-based stories about the growing payoff to skill (e.g., Acemoglu, 2003; Autor et al, 2008). Although “political economy” analyses of inequality have become increasingly popular, they mainly focus on the political underpinnings of after-market interventions (e.g., taxes, welfare payments) rather than on the political underpinnings of the market itself (e.g., Baramendi and Anderson, 2008; Brady, 2009; Bartels, 2010; Hacker and Pierson, 2010; Kenworthy, 2011; Manza 2011; Frank 2011).¹

The core problem with this existing literature, in our view, is that it either operates narrowly within a competitive market framework or treats the competitive market as an unanalyzed backdrop against which the politics of after-market redistribution occurs. There are, to be sure, some recent political economy accounts that seek to explain the rising wealth and income of the top 1% in term of their power to shape the rules of markets (e.g., Stiglitz 2012; Reich 2012). In this article, we offer a programmatic statement on rising income inequality that, like this newer literature, refocuses attention on the existing institutions in so-called competitive

¹ The political economy literature includes some discussion of labor market rent, but it’s focused mainly on executive compensation (e.g., Hacker and Pierson 2010; cf. Baker 2006).
market economies. We argue, however, that market failure and the income inequalities it generates is as important to understanding income disparities between the middle and working classes as it is to understanding the disparity between the 1% and the 99%.

The conventional wisdom on the takeoff in inequality embodies both a diagnosis of its sources and a prescription for its reduction. Under the formulation favored by many institutional scholars, market competition is responsible for the high baseline level of inequality in liberal market economies (LMEs), and a more recent wave of deregulation and other competition-enhancing reforms pushed levels of inequality in LMEs even higher. The resulting mantra is that competition breeds inequality and increasing competition breeds ever more inequality. Insofar as the policy goal is to treat inequality, the twin prescriptions emerging from this diagnosis are either to redistribute post-market income or to increase pre-market skill through greater investment in education (see, e.g., Obama, 2009).

These competition-based accounts of inequality and its takeoff are incomplete at best. Even in ostensibly liberal market economies, much inequality is generated by competition-suppressing institutions that deliver income to those at the top of the income distribution. These institutions are often veiled from view and, as a result, have not been targeted by the various “competition-enhancing” reforms occurring at the bottom of the income distribution. The implication is that the rapid growth in inequality in LMEs occurred not only because of competition-increasing change at the bottom (e.g., declining union power, globalization), but also because of competition-reducing processes at the top. If we are correct in this diagnosis, the prescription is clear: We can take on poverty and inequality by repairing non-competitive labor and capital markets and thereby reducing the inequality that such failed markets generate.
The concept of rent is key to our argument. We adopt the usual definition of rent as returns on an asset (e.g., labor) in excess of what is necessary to keep that asset in production in a fully competitive market (e.g., Tullock, 1967; Tollison, 1982; Congleton et al., 2008, 2010). By this definition, rents exist wherever (a) demand for an asset exceeds supply and, (b) the supply of the asset is fixed, whether through “natural” means or through social or political barriers that artificially restrict supply. The “fixed supply” condition implies that labor cannot respond to the price increases that arise when demand exceeds supply. In contemporary labor markets, rent takes on many well-studied forms, including the wage premiums associated with the minimum wage (e.g., Neumark and Wascher, 2010), the union wage and the associated “spillover” effects (e.g., Freeman and Medoff, 1984), between-industry wage differentials (e.g., Katz and Summers 1989; Cha and Morgan 2010), and the wage premiums that accrue to licensing and related types of occupational closure (e.g., Weeden, 2002; Kleiner and Krueger 2008). \footnote{We address here the rents that accrue to individuals by virtue of their labor assets (e.g., Sørensen 2000). We are less concerned with the rents accruing to firms (by virtue of their monopoly or quasi-monopoly on an asset) except insofar as these rents are shared unevenly between capitalists and workers.}

It is well known that some of the institutions through which workers have historically been able to capture rents have weakened in the last 35 years. The two main developments of interest are the decline in the real value of the minimum wage during the 1980s, and the decline in the proportion of the labor force that is unionized. In a now-classic analysis, DiNardo, Fortin, and Lemeiux (1996; Lee 1999) concluded that the minimum wage “held up” the lower tail of the earnings distribution in the late 1970s but that, as the real value of the minimum wage declined, the lower tail quite quickly sank. More recently, there has been some debate about the extent to which the changing value of the minimum wage can indeed explain rising inequality, but even
the skeptics suggest that it at least had a nontrivial spillover effect on workers who earned somewhat more than the minimum wage (Autor, Manning, and Smith 2010). 3

The effects of declining unionization are less controversial. Most obviously, unions are understood to raise wages by providing members with a monopoly over certain jobs, in effect preventing employers from driving down wages by pitting union and nonunion workers against one another. At the same, unions raise the wages of nonunion workers because (a) nonunion employers wish to forestall unionization, and (b) the union wage generates widely shared norms about proper pay that are then costly for employers of nonunion workers to ignore. When these effects are taken into account, Western and Rosenfeld (2011) have shown that approximately one third of the rise in inequality between 1973 and 2007 is attributable to the decline in unionization (see also Card, Lemieux, and Riddell 2003).

The foregoing accounts of rent destruction are, we argue, not so much incorrect as incomplete. By focusing on the decline of institutions that generate rents for workers at the bottom of the wage distribution, the prevailing assumption in much of this literature is that rent destruction, not rent creation, is the main dynamic characterizing advanced industrial societies. In his seminal statement outlining a rent-based theory of social class, Sørensen (2000, p. 1555) predicts that “rents will disappear from structural locations in the labor market,” with the result being a transition toward a “structureless society” without the “nooks and crannies” in which competition is suppressed and rent can be collected. At the same time, Sørensen (2000) also

3 Neumark and Wascher (2010, p. 279) note that “living wage” campaigns, which in the U.S. target municipalities and other local governments, are often driven by unions that seek to forestall the privatization of municipal services and protect union bargaining power. For our purposes, it doesn’t much matter whether unions or some other organizational agent are behind minimum wage campaigns.
locates rising income inequality in the 1980s and 1990s in the newfound incentive of managers to capture a greater share of composite rents, a theme later taken up by Morgan and his colleagues (Morgan and Tang 2007; Morgan and Cha 2007; Cha and Morgan 2010). With these notable exceptions, the bulk of theoretical and empirical efforts to develop a rent-based account of rising income inequality have focused on rent destruction and the diffusion of a market-based logic that exacerbates inequality.

We argue, to the contrary, that rent-destruction and rent-creation have been deeply asymmetric: Just as rent is gradually being destroyed for workers at the bottom of the income distribution, it is also gradually being created at the top of the distribution. This rent-creation has not occurred solely through industrial restructuring and, in particular, the “financialization” that has characterized LMEs (see, e.g., Tomaskovic-Devey and Lin 2011; Phillipon and Reshef 2009; Yeldan 2002). Rather, it has been generated through a much broader set of institutional shifts that have created new rents for those at the top of the income distribution, even as rents for those at the bottom have been destroyed or redistributed.

In this article, we discuss four such forms of top-end rent: occupation rent, education rent, capitalist rent, and managerial rent. Although most of these forms have been identified in the existing literature on rent, they are largely absent from the literatures on comparative inequality and, especially, on trends in inequality. In the sections that follow, we discuss each of our four types of rent and how it affected inequality trends in LMEs, and we lay out the types of analyses that might be undertaken to test a rent-based account. We begin, however, by rehearsing the conventional wisdom on how inequality is generated in LMEs and why it is increasing. This sets the stage for our more skeptical account. As noted above, we will argue that the high and rising inequality of LMEs is not an inevitable consequence of competitive market institutions,
but instead is attributable to the particular types of rent that flourish within the U.S. and, we suspect, within most LMEs.

The mantra on inequality in LMEs

The conventional claim within the varieties of capitalism (VoC) literature is that income inequality in LMEs is intrinsically higher than inequality in coordinated market economies (CMEs). This claim appears in Hall and Soskice’s influential VoC statement (2001, p. 21) and is repeated throughout the voluminous literature that followed (e.g., Pontusson, 2005; Beramendi and Anderson, 2008; Soskice, 2010).

The empirical relationship behind this claim is indisputable, but the key question is why inequality is higher in LMEs than in CMEs. With few exceptions, the VoC literature simply takes it for granted that LMEs, resting as they do on market contracts to coordinate exchanges, generate high inequality. The explanatory effort thus presupposes high inequality in LMEs and focuses on the institutions in CMEs that limit the rise of inequality. Within the VoC literature, CMEs have all manner of institutions that limit the rise of inequality (e.g., collective bargaining agreements), whereas LMEs are reduced to ideal-typical competitive markets and thus play the role of institution-free foils (see also Howell 2003). The implication is that high inequality within LMEs is a consequence of intrinsic inequality-generating features of competitive market economies that have largely gone unchecked. We turn this approach on its head, focusing not on the institutions that suppress inequality in CMEs but on the institutions that generate inequality in LMEs.

What is it about competitive market economies that putatively generate so much inequality? The microeconomic literature identifies six mechanisms of interest. As will be apparent, some of these mechanisms obtain in perfectly competitive economies, while others
become operative in the context of minimal departures from that ideal type, in particular
departures that allow for imperfect information. We’ll rehearse these six mechanisms below and
then identify those featured in the VoC literature as the primary source of high inequality in
LMEs.

**Conventional sources of inequality in LMEs**

In all economies, some workers are blessed with abilities that make them more
productive in the context of that economy, resulting in higher earnings. The man who is so lucky,
for example, as to be 7-foot tall, agile, strong, coordinated, and athletic is well-suited to be a
center in the National Basketball Association (NBA). The extremely high pay of NBA centers
may be understood as the rent that accrues to these abilities, abilities that are in fixed and limited
supply. If height and other basketball-enhancing attributes were in ready supply or could be
easily acquired through surgical or pharmaceutical means, then NBA centers would be exposed
to more competition and their pay would be driven down by virtue of that competition. It follows
that rents on ability arise when there’s a fixed supply of inborn traits and a demand for those
traits that exceeds supply.

Similarly, some workers have inborn tastes that make particular activities especially
rewarding, such that they are willing to forego some amount of earnings in exchange for the
utility that arises from indulging those tastes. It’s often suggested, for example, that some people
are natural caregivers and are willing to accept low earnings in exchange for the on-the-job
rewards that, for them, arise when they tend children. If the distribution of inborn tastes

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4 This is an imperfect example because NBA centers are represented by a players’ union and, until the advent of free agency, worked under monopsony conditions.
generated too few people willing to accept low pay in these child-tending jobs, the shortage in the supply of child-tending labor would drive wages in child care occupations higher and, in a competitive economy, lead to an influx of child-care workers. The implication is that a given distribution of tastes, unless it perfectly matches demand, may disrupt this clearing flow of labor and allow inequalities in pay to persist.

The preceding example pertains to taste for a particular line of work (i.e., child-tending), but more general tastes can also have an inequality-generating effect. A taste for “deferred gratification,” for example, can increase downstream productivity and earnings by motivating investments in schooling and other human capital, while a taste for “hard work” leads to differences in the amount of hours spent earning money and the amount of effort that’s expended each hour. As long as these tastes are fixed, and workers are willing to trade off pay for them, then the inequality that they generate may be understood as rent-based. Clearly, it’s a form of rent that many people find tolerable and even desirable, given that any restrictions on the expression of tastes is viewed as an unwarranted deprivation of liberty. But it is nonetheless a form of rent.

The inequality generated by inborn tastes should be distinguished from that generated by tastes that are acquired through socialization by the family, schools, or peers. It is often claimed, for example, that children in impoverished neighborhoods or families do not develop a taste for deferred gratification and are therefore reluctant to invest in education, even assuming opportunities for these investments are available (see, e.g., Breen and Goldthorpe, 2001). These inculcated tastes, like inborn tastes, can also generate rent by virtue of their scarcity relative to some tastes, such as the taste for deferring gratification or for hard work, could alternatively be understood as the “ability” to defer gratification or to engage in hard work. It’s unnecessary for our purposes to privilege either interpretation.
demand. The root source, however, is a particular configuration of social institutions, not genes, and hence the resulting rents should be understood as institutional in origin.

*Compensating differentials:* In all economies, some jobs are so unpleasant, risky, or undesirable that the wage rate must be increased to motivate enough workers to take such jobs (e.g., Rosen, 1986). Although the simple bivariate relationship between desirability and wages is positive, the standard presumption is that if all other sources of inequality were netted out, the relationship would be negative. If one focuses on income inequality (as opposed to “utility inequality”), it follows that compensating wage differentials can explain some portion of the inequality observed in LMEs.

*Human capital investments:* Because human capital investments, such as schooling, bring about higher productivity, employers will pay more for workers who have made these investments. This higher payment may also be understood as compensation for training costs and, as such, will only yield inequality in cross-sectional earnings. In the absence of barriers to the flow of labor, lifetime earnings will be equalized across workers, who will invest in human capital up to the point where investments equal expected returns.

This highly stylized human capital story is complicated by the distribution of tastes and abilities, insofar as the decision to invest in human capital may itself require learned or inherited tastes or abilities that are in short supply. It may well be that only those young people with a well-developed taste for deferred gratification are willing to make a costly investment in medical training. If there are naturally occurring (i.e., genetic) or institutionally generated (e.g., class-specific socialization) shortfalls in this particular taste, the wage returns of doctors will exceed what would prevail if labor freely flowed to the high-return investment. The resulting wage returns in excess of the costs of training are properly understood as rent.
Efficiency wages: In some markets, managers may pay their workers in excess of what the market demands, as doing so makes them more efficient or productive (e.g., Shapiro and Stiglitz, 1980; Akerlof and Yelen, 1986). When direct measurement of work effort is costly, overpayment in the form of efficiency wages becomes the cheapest solution to the problems of shirking or malfeasance. The simple logic here is that, because the likely pay cut associated with getting fired is high, workers will devote maximum effort to their jobs to avoid getting fired. Alternatively, firms may “overpay” in order to induce high-productivity workers to apply for an open position, thereby reducing worker selection and monitoring costs. In both cases, the fundamental problem is that acquiring information about likely productivity or on-the-job performance (i.e., monitoring) is so costly that it is cheaper to overpay. It follows that inequality arises in LMEs because some firms pay their workers efficiency wages and others do not.

Statistical discrimination: Because it is often too costly for firms to measure anticipated productivity at the individual level, they may resort to group-level measurements as a shortcut assessment of individual-level capacity. Members of some groups (e.g., whites, males) may be paid especially high wages without such wages reflecting true individual-level differences in ability or productivity (Phelps, 1972; Arrow, 1973). This mechanism creates inequality that can’t be attributed to ability or tastes, although it is again related to the information shortfalls that generate efficiency wages.

The foregoing list of the sources of inequality in competitive economies is standard fare, but we’ve tried to be more rigorous than usual in distinguishing between sources of inequality that imply rent and those that do not. The distinctive feature of this list, for our purposes, is that it acknowledges only two types of rent: (1) the “endowment rent” that arises because ability or
tastes are fixed in a distribution that does not match demand, and (2) the “information rent” that arises because firms can’t directly measure future or current productivity, thereby generating efficiency wages and statistical discrimination.

The VoC literature, with its rational-functionalist orientation (see Streeck 2010), accepts this account of the sources of LME inequality. In so doing, it implicitly recognizes some forms of rent within LMEs but ignores others. It’s simply assumed that LMEs are so close to the perfect-competition ideal type that only the “inevitable” rents of modern economies, those attributable to the natural distribution of endowments or to high information costs, will be in evidence. It follows that, if only LMEs would adopt the inequality-suppressing institutions of CMEs (e.g., collective bargaining, strong unions), inequality in those countries would be greatly reduced.

This line of reasoning rests on a misdiagnosis of the sources of inequality in LMEs. There’s good reason to suspect that LMEs are rife with rent, not just endowment and information rent, but rent that has deeply institutional sources. These institutional rents generate levels of inequality in LMEs that far exceed what would be observed if the mechanisms reviewed above were the only sources of inequality. As we’ll discuss below, such rents tend to develop at the top end of the labor market, meaning that they generate the peculiarly top-heavy form of inequality found in LMEs (see Figure 1). The upshot is that the much-vaunted inequality-suppressing institutions of CMEs would have only limited utility in combating inequality in LMEs.

[insert Figure 1 about here]

The mantra on trend in inequality
If the conventional wisdom about the LME-CME gap in income inequality fails to appreciate the generative role of institutional rents, so too does the conventional wisdom about trend in LME inequality. The long-preferred economic explanation for the takeoff in wage inequality, skill-biased technological change (SBTC), is by now quite familiar: Exogenous technological changes increased the demand for, and marginal productivity of, highly skilled workers while it reduced the demand for low-skill workers (for a review, see Acemoglu, 2003; see also Autor et al., 2008; Card and DiNardo 2002). As a result, the wages of skilled workers rose dramatically, while the wages of low-skilled workers fell.

In the SBTC account, rising inequality is a byproduct of smoothly functioning labor markets that are responding to an exogenous shock, namely technological change. The proximate source of growing inequality is rising returns to skill and hence human capital investments. In a competitive economy, workers should respond to price signals by investing in the training needed for high-premium jobs, thereby increasing the supply of labor for those jobs and driving down their wages. The temporary, “quasi-rents” generated by a short-term shortage of skilled labor will, through the usual equilibrating flows, be eliminated over time. We should see wage premia in the long term only insofar as they rest on (a) abilities that cannot be acquired through education or training, or (b) tastes for deferred gratification (and other prerequisites of investments) that are in short supply and are so entrenched that they do not respond to wage signals. The latter wage premia can, as noted above, be understood as rent on endowments.6

All manner of complexities could prevent markets from equilibrating in the ever-present

6 We acknowledge the standard sociological view that tastes and abilities are socially produced through institutional arrangements. Although we don’t deny the social underpinnings of taste, the rent created this way is more subtle and resistant to policy intervention than the four institutional forms of rent we emphasize (i.e., occupational, educational, managerial, capital).
short run. For example, Acemoglu (2002) argued that skill-biased technological change is endogenous, given that a ready supply of high-skilled workers creates the conditions for firms to implement ever higher-skill production regimes. This does not resolve the more fundamental problem of explaining persistent market disequilibria. After all, even if the “goalposts” keep moving, the forward-looking worker will still overinvest in skills for the present economy in anticipation of ever-increasing skill demands in the future. The answer to this puzzle rests in appreciating the role of institutional barriers to the free flow of labor. We suggest, in other words, that high returns to skill persist because rent-generating institutions prevent labor from responding to price signals and create permanent market disequilibria.

Although SBTC remains the dominant explanation of rising income inequality, it is certainly not the only explanation on offer. As we noted above, the institutionalist account has it that LMEs once had at least some CME-like institutions protecting low-skill workers (e.g., unions, the minimum wage), but as these institutions gradually dissipated, LMEs became purer in form and inequality took off. There is still debate about the relative contribution of these shifts to rising wage inequality (e.g., Autor et al., 2008; Autor et al., 2010). The critical feature of these arguments, for our purposes, is that they focus exclusively on the demise of the institutions that allow workers at the bottom of the wage distribution to capture rent. These arguments are thus well-suited for the purpose of explaining the decline in income at the bottom of the LME income distribution.

Can these institutionalist accounts also explain the rise in income at the top of LME distributions? If one sought to do so, it would presumably require a story about how the rents stripped away at the bottom are then transferred to the top. Although the rent formerly accruing to workers could be destroyed altogether, as is the case when barriers to competition are
eliminated (e.g., via globalization or anti-trust enforcement), it’s also possible that such rent could be redistributed to the top. In research inspired by Sorensen’s efforts, Morgan and his colleagues show that, in the United States, low-skilled workers in formerly rent-rich industries lost wages relative to their compatriots in rent-poor industries (e.g., Morgan and Tang 2007), while managers and professionals amassed greater wealth as stock prices grew (Morgan and Cha 2007).

In our view, rent redistribution of this sort, while important and intriguing, does not fully capture the range of institutionally generated rents in contemporary LMEs. The latter rents have also emerged from new constraints on the supply of skilled labor (e.g., new credential requirements, more restrictive licensing requirements) and from barriers that prevent the rising demand for skilled labor in already-closed positions from being met by growing supply. Critically, these rents have disproportionately benefited workers at the top of the income distribution, not only the much-vilified 1% but workers further down the income distribution as well (see Figure 2).

[Insert Figure 2 about here]

**Top-end institutional rents in LMEs**

In this section, we introduce the four main forms of institutional rent and how they are implicated in the spectacular run-up of LME inequality. Although we focus on the U.S. case, the growth in top-end institutional rent is likely also implicated in the take-off in inequality in other liberal market economies.

*Occupational closure:* We begin with the twin claim that occupational closure is an important rent-generating institution and that such closure is also an important source of rising income inequality. By occupational closure, we’re referring to the practice of establishing
barriers that protect occupational incumbents against competition from others who might want (a) to enter the occupation, or (b) to provide the same or similar products or services from a “close” or competing occupation (see Weeden 2002). These barriers raise the wages of incumbents by increasing an occupation’s control over the supply of labor and by reducing competition from other potential providers of the product or service (Weeden, 2002; Kleiner, 2006; Kleiner and Krueger, 2008).

Have the rents stemming from occupational closure increased over time? Although this remains an open empirical question, the available evidence shows a rapid increase in the proportion of workers in licensed occupations. In the United States, this proportion now exceeds the proportion of unionized workers (Kleiner 2006), an increase partly due to the expansion of licensed occupations and partly due to the diffusion of licenses to new occupations. The result in either case is that ever more rent is being collected at the top of the income distribution (where most licensure is found). In and of itself, this development does not challenge the SBTC story that demand for skill is growing, but it does suggest that the quasi-rents in skill-demanding occupations will persist over the long run only when occupational closure prevents labor from flowing in. That is, rising demand for skill is alone insufficient to account for the takeoff in income inequality, as workers in a truly competitive market will naturally opt to acquire the requisite skill and thereby drive the premium back down. If inequality is to be locked in, the beneficiaries of the rising demand must have tools at their disposal (e.g., licensure) that allow them to control competition and prevent other workers from cashing in.

Education rent: The mechanisms behind education rent are similar, but they focus less on barriers to practicing certain skills and more on the acquisition of the skills themselves (see also Bol and Weeden 2012). It is by now widely appreciated that returns to education have increased
in the last four decades, initially driven by rising returns to a college degree and, more recently, by rising returns to post-baccalaureate degrees. In accounting for these rising returns, we suspect that workers aren’t opting against education because they are lazy, irrational, or lack the required pro-investment tastes, but rather because various constraints prevent them from acting on the market signal. The supply of potential college students is kept artificially low because children born into poor families are trained in poor schools that don’t prepare them for college, while the number of available university degrees (i.e., the “demand” for students) is kept artificially low because administrative or institutional rules, rather than price signals, determine that number.

As a result of these institutionalized bottlenecks, the supply of college-educated labor has not increased as rapidly as one would anticipate in an era of rising returns (see also Goldin and Katz, 2008). Indeed, only 30 percent of each birth cohort now earns a college degree, which is not much higher than in the 1970s (Hout, 2009; 2012). These bottlenecks in the supply of college-educated labor imply that those fortunate enough to secure a college degree from a traditional non-profit institution are artificially protected from competition and thereby reap rent. This is an underappreciated form of market failure and likely a major source of rising income inequality.

7 The rising return to post-baccalaureate degrees is not well-known but shows up in our unpublished analyses of the Current Population Survey (CPS).
8 This market failure is not very successfully addressed by the recent rise of for-profit educational institutions because they still graduate a quite trivial share of post-secondary degree-holders and because the resulting credentials don’t yield much of a market payoff in employment prospects or earnings (e.g., Deming, Goldin, and Katz 2012; Chung, 2009; Grubb 1993). It is too soon to tell whether massive on-line courses (MOOCs) will make the college-educated market more competitive.
*Capitalist rent:* In the case of capitalist rent, our focus shifts from rising inequality in wages and salaries to the increasing share of national income that goes to capital rather than labor. By some estimates, this share rose over the last 40 years from 34 to 40 percent of national income, a sizable increase if not quite as dramatic as the increase in income inequality (Kristal 2010, 2011). The conventional explanation for this shift is that “capital-biased technological change” increased the productivity of capital relative to labor (see, e.g., Kristal 2010) and therefore the share of income going to capital. This account, like the SBTC story, ignores sociopolitical factors in favor of narrowly construed technological ones.

In the rent-based account, the emphasis is instead on capitalists’ newfound leverage to appropriate rent that workers were once able to secure. The growing power of capitalists arises because (a) unions have weakened and no longer protect workers against competition from other domestic workers, and (b) international barriers to the flow of capital have likewise weakened and no longer protect domestic workers against competition with foreign workers (e.g., Morgan and Zang 2007; also Katz & Summers 1989). The bargaining power of capital increases insofar as workers must now negotiate without the protection once afforded by unions or by “territorial closure” in the form of an implicit national monopoly on the provision of labor (Brubaker, 1993). Additionally, capitalists in some industries have achieved higher market concentration of late and firm sizes have grown steadily (White, 2002), developments that not only increase firm rents but, in conjunction with weak unions and strong threats of “offshoring,” provide additional leverage for capitalists to capture a greater share of the firm rents. This process is especially pronounced in the financial sector and in the financial service arms of nonfinancial firms (Tomaskovic-Devey and Lin 2011), but it is not limited to those sectors (Kristal 2010).
Managerial rent: The literature on managerial rent is relatively well developed. In the managerial sector, rents are understood as stemming from three main sources: pay-setting institutions that provide managers with performance-based bonuses; pay-setting institutions that allow the interests of board members to intrude; and new forms of managerial closure. The first form of managerial rent emerges as a solution to a classic principle-agent problem: In order to prevent managers from making business decisions that advance their own interests over those of the firm (e.g., Stiglitz and Edlin, 1995), owners have tied managerial pay to firm performance (e.g., through stock options) and, as a result, have raised managerial pay and increased inequality (Sørensen, 2000; Morgan and Tang, 2007). The second source of managerial rent refers, by contrast, to pay-setting institutions that divorce managerial pay from firm performance. The classic example here is the practice of allowing boards of directors, who have a private interest in acquiescing to the CEO, to effectively set the CEO’s pay (for a review, see Bebchuk and Wiesbach 2009). Likewise, there’s a growing literature on benchmarking norms that set CEO pay at the “going rate,” an institutional practice that provides a market-pay veneer because it’s presumed that the going rate isn’t artificially raised by rent (see DiPrete et al., 2010). Much debate persists over whether the high pay secured through these pay-setting practices reflects marginal productivity or rents (e.g., Gabaix and Landier 2008; Bebchuk and Wiesbach 2009; Murphy and Zabonjik 2007).

In our view, these debates over the principal-agent problem and CEO compensation have distracted us from appreciating the growth in rents enjoyed by the vast cadre of middle managers, not just top executives. These rents stem from a special form of occupational closure that creates a disjuncture between the supply of managerial labor and the demand for it and, in turn, generates a broad-based increase in managerial pay. The demand story behind closure-
based rents in the managerial sector is well known: (a) globalization introduces a new need to supervise and oversee far-flung operations, (b) product and service markets have been further expanded through new technologies, and (c) the intra-firm division of labor has become increasingly complicated and has thereby required new layers and types of control and supervision (e.g., Frank and Cook 1995).

This increase in demand yields rent because the supply of labor is prevented from straightforwardly meeting the increase. Just as demand for managerial capacity was growing, managers embarked on a classic professionalization project, primarily through managerial credentialism. In the context of this project, formal education for managers went from “ornamental to essential” (Mayo et al., 2006, p. 119), with the MBA in particular emerging as an important screening device and source of social capital. To be sure, business schools have also expanded rapidly, and non-academic purveyors of business training have emerged as alternatives (Pfeffer and Fong 2002). Even so, the number of students seeking entry into business schools still far exceeds the number of MBAs produced, as indicated, for example, by Graduate Management Admissions Test registrants in the U.S. This newfound credentialism, while likely a less effective restriction on supply than occupational licensure, is nonetheless a source of rent that may be as important as principal-agent rent and CEO overcompensation.

**Conclusion**

We have argued that LMEs are rent-laced economies and that asymmetries in institutional rents account for the high levels, and rising levels, of inequality in LMEs. This formulation belies the oft-repeated mantra that competition begets inequality and that growing competition begets growing inequality. We have suggested, to the contrary, that the high levels
of inequality in LMEs are in part attributable to institutional rents, and that rising income
inequality in LMEs is caused by deeply asymmetric institutional changes that have destroyed
rent at the bottom of the income distribution and allowed ever-increasing rents to be extracted at
the top of the income distribution. Although this account of rising income inequality is still little
more than a hypothesis, we think it’s at least worth subjecting to as much scrutiny as the SBTC
hypothesis.

What might this empirical agenda entail? Consider, first, our claim that occupational
closure, and not skill upgrading alone, underlies persistently high and growing pay for skilled
occupations. At minimum, the closure argument predicts that the takeoff in inequality in LMEs
occurred between occupations, not just within them (see Weeden et al., 2007; Mouw and
would show that wage growth was most pronounced among (a) occupations with well-developed
closure at the start of the takeoff, and (b) occupations that ramped up their closure before or near
the beginning of the takeoff. The closure effect should be especially apparent among occupations
that experienced a pronounced increase in demand (often via computerization and related
technological change). Conversely, occupations (e.g., clerical workers) that upgraded but that
lack closure should not show a persisting upward wage trajectory, precisely because they haven’t
the capacity to close off against the burgeoning supply of laborers who can secure the requisite
training.

In assessing education rents, we might begin by asking why the growing payoff for
schooling has not been met by an equilibrating increase in schooling (see also Hout 2012), and,
in particular, whether the main bottlenecks are the supply and demand forces we’ve identified.
The first question to take on is whether trends in the returns to schooling continue to reveal a
takeoff even after trends in occupation rent are parsed out. Because highly-educated workers tend to be found in rent-collecting occupations (e.g., managers, doctors, lawyers), the standard Mincer-style regressions conflate changing returns to education with changing occupational rent, with the resulting possibility that the seeming increase in returns in education may be nothing more than rising occupation rent in disguise. If, however, the substantial upward trend in returns to schooling persists with detailed occupation controls in place, the next question to ask is how this trend is generated and, in particular, whether it can be attributed to (a) a declining supply of youth who are well prepared for college (perhaps because of a growing preparatory disadvantage among poor children); and (b) a declining number of slots among high-payoff colleges (attributable either to declining state funding for public schools or a slot-rationing strategy among elite private institutions). The market failure hypothesis receives support insofar as the supply of college-educated labor does not well respond to changes in the payoff to college (under appropriate assumptions about the lag structure).

The capital rent hypothesis can be assessed by examining, at the industry level, the effects of various types of closure or market failure (e.g., unionization, concentration) on labor’s share of income within industries (see, e.g., Kristal 2011). Because the trend in labor’s share varies considerably by industry, there’s an opportunity to assess whether that variability reflects differences in the rate of computerization or, as we suspect, differences in trends in foreign competition and other sources of rent. Finally, a managerial rent hypothesis requires us, at minimum, to show that managerial occupations have indeed experienced a relatively steep takeoff in wages, even with controls in place for rising education returns. We also need to show that this changing payoff is associated with the emergence of institutions (e.g., the MBA) that worked to constrict the supply of high-level managers. The underlying demand for managers is
unobservable, but the rent hypothesis becomes more plausible insofar as the constriction of supply is linked both to the rise of closure institutions and the takeoff in managerial pay.

If our market failure account is indeed on the mark, what are the implications for efforts to mitigate poverty and inequality? The U.S. and other LMEs have long fashioned their inequality-reducing interventions under the assumption that inequality is an unfortunate by-product of highly efficient competitive markets. This model leads to a focus on pre-market skill enhancement (e.g., education) and after-market redistribution (e.g., through taxation and redistribution) rather than market repair. We have argued, by contrast, that LMEs would end up with less inequality, not more, if various forms of closure and supply bottlenecks were purged from our labor market institutions. Although redistributive tax policy is justifiable on a host of grounds, it’s just as important to fashion inequality-remediating policy that is guided by the simple principle of repairing rent-ridden markets. Because public opinion in LMEs is, on average, quite sympathetic to the market principle, the prospects for reform that focuses on eliminating corruption, closure, and bottlenecks may be greater than the prospects for significant and lasting after-market redistribution.
References


Kristal, T. (2012). It's good to be a capitalist: why capitalists are getting more and workers are getting less. (Working Paper.) Palo Alto: Center for the Study of Poverty and Inequality.


Figure 1: Top 10% income shares in CMEs and LMEs

Source: World Top Incomes Database (Alvaredo et al., 2011).
Source: Picketty and Saez, 2012, Figure 1.

Figure 2: Top 10% income share in the United States, 1917-2010.