

**Asset-Price Inflation and Rent Seeking:
A Total>Returns Profile of Economic Polarization in America**

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Based on work with Dirk Bezemer

with charts by Howard Reed

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(sources and references to be added)

SUMMARY

Section 1 – Introduction and overview

Debt-Financed Asset-Price Inflation is Finance Capitalism’s defining dynamic, not tangible capital investment to make profits by producing goods and services.

Section 2 - The case for adding balance-sheet “capital” gains to national income

The circular flow of production, consumption, earnings and taxes is much smaller than the magnitude of capital gains on real estate, stocks and bonds. The source of most wealth is rising asset prices achieved by debt leveraging and financial engineering, not earnings and savings out of production and consumption.

Section 3 - A new framework: subtract rental and financial “services” from the NIPA as non-products and transfer payments

The *rentier* overhead, including fictitious depreciation and imputations of non-real income or products, make the actual national product substantially less than is reported in the National Income and Product Accounts (NIPA)

Section 4 - From value-added to total returns

Incorporating Total Returns into economic statistics is a key to explaining today’s widening wealth disparities

Section 5 – Conclusion: toward a more realistic profile of the financialized *rentier* economy

Asset-Price Inflation and Rent Seeking:

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“More than half of all Americans feel pressure and strain, according to the April 2019 Global Emotions Report published by Gallup. Most (55%) Americans recall feeling stressed much of the day in 2018. That’s more than in all but three countries globally. Nearly half of Americans felt worried (45%) and more than a fifth (22%) felt angry. ‘Even as their economy roared, more Americans were stressed, angry and worried last year than they have been at many points during the last decade,’ Julie Ray, a Gallup editor, wrote in the summary report.”

USA Today, April 26, 2019

“For me the relevant issue isn't what I report on the bottom line, it's what I get to keep. ... I love depreciation.”

Donald Trump, The Art of the Deal

1. Introduction and overview: A debt-strapped era of downward mobility

Those who praise the post-2008 economy as a successful recovery point to the fact that the stock market has soared to all-time highs, while the unemployment rate has fallen to a decade-low. But is the stock market a good proxy for how the overall economy is doing? The low reported unemployment rate sidesteps the predominance of minimum-wage jobs, part-time “gig” work, and the fact that the Federal Reserve’s *Report on the Economic Well-Being of U.S. Households in 2018* reports that 39% of Americans do not have \$400 cash available for a medical or other emergency, and that a quarter of adults skipped medical care in 2018 because they could not afford it.¹ The latest estimates by the U.S. Government Accountability Office (GAO) report that nearly half (48

¹ <https://www.federalreserve.gov/publications/files/2018-report-economic-well-being-us-households-201905.pdf>, p. 22 (Fig. 11).

percent) of households headed by someone 55 and older lack any retirement savings or pension benefits.² Even in what the press calls an economic boom, most Americans feel stressed and many are chronically angry and worried. According to a 2015 survey by the American Psychological Association, financial worry is the “number one cause of stress in America today.”³

The Fed describes them as suffering from “financial fragility.” What is fragile is their economic status and self-worth, teetering on the brink of downward mobility. Living in today’s financialized economy creates stresses that seem more damaging emotionally than living in a poor country. America certainly is not a poor country, but it has become so debt-ridden, and its wealth and income growth so highly concentrated, that much of its population is emotionally worse off than that of almost any other country in the world.

The U.S. economy’s soaring wealth and income finds its counterpart on the liabilities side of the balance sheet. Rising stock prices have been fueled by corporate stock buyback programs and debt leveraging, not earnings from new tangible investment and employment. And rising real estate prices reflect the decline in interest rates, enabling a given rental flow to be capitalized into higher bank loans and market prices. Additionally, the wave of foreclosures on junk mortgages and debt-strapped new home buyers has reduced home ownership rates, forcing more of the population into a rental market, whose rising charges for housing have supported general real estate prices. Thus, these capital gains do not reflect a thriving economy, but a higher-cost one that is polarizing between creditors and debtors, property owners and renters, and the financial sector vis-à-vis the rest of the economy.

The main culprit for the economy’s falling growth rate and the general middle-class economic squeeze is debt – or more specifically, the burden of having to pay it back, with penalties, fees and lower credit ratings. The mainstream press depicts the rising market price of homes as a benefit to homeowners, a capital gain as if they almost were real estate speculators or capitalists in miniature, not wage-earners running up debt. GDP statisticians include the rise in valuation of owner-occupied real estate and the rising rents it saves homeowners from having to pay as adding to GDP. But

² William E. Gibson, “Nearly Half of Americans 55+ Have No Retirement Savings or Pension Benefits,” AARP, March 28, 2019. <https://www.aarp.org/retirement/retirement-savings/info-2019/no-retirement-money-saved.html>

³ Source: American Psychological Association (2015). “American Psychological Association survey shows money stress weighing on Americans’ Health Nationwide,” February 4, 2015.

<http://www.apa.org/news/press/releases/2015/02/money-stress.aspx>.

homeowners do not receive a corresponding income for living in their homes, even if rents rise in their neighborhood. And debt-financed home-price inflation has become a major factor squeezing family budgets in today's world.

When they fall behind in their payments and are subject to late fees and higher interest rates, these payments are treated as an addition to GDP ("financial services"), as if the economy is getting richer. So when the specific components of what seems to be empirical statistical evidence of affluence are analyzed, they consist not of real product and prosperity but transfer payments from the economy at large to the Finance, Insurance and Real Estate (FIRE) sector.

Payments on the economy's rising debt should rightly be viewed as a subtrahend from national income. But the GDP accounting format treats this rising debt as a necessary cost of production. In this line of theorizing, creditors provide a productive service whose value is reflected in the rate of interest and the magnitude of fees and penalties. Ultra-low interest rates, resulting from financial lobbying pressures, have held down the cost of carrying this debt, but these low official rates mask the reality that many debtors fall behind and have to pay penalty fees and high penalty interest rates.

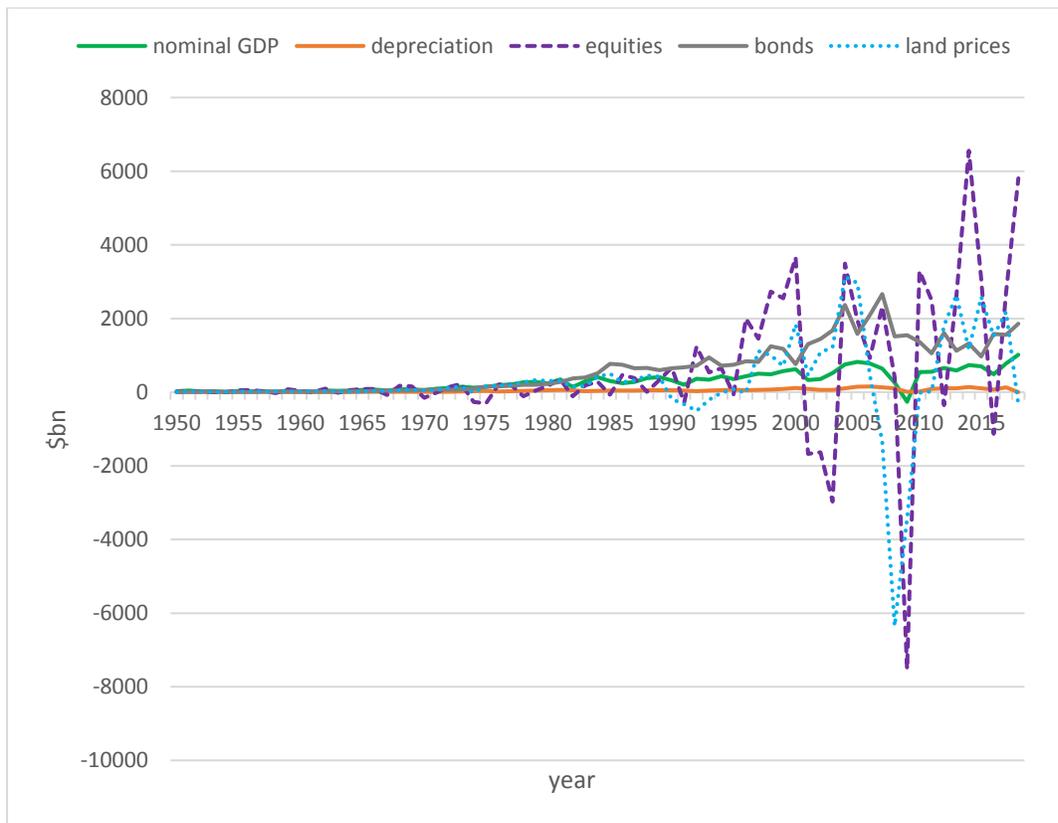
These payments are *added* to today's GDP measure, even as they leave less family income available to be spent on products. The result is a statistical confusion concerning how much GDP growth is actual income and product growth, and how much is rent extracted from disposable personal and corporate income. That is the basic conceptual issue addressed in this paper.

The key to understanding the U.S. economy is not so much GDP as capital (asset-price) gains and the offsetting debt burden financing these gains. This financialized overhead is not real growth. It does not make the economy richer. This paper explains why, and provides a statistical format to measure the magnitude of rent extraction or the FIRE sector on the "product" side of the economy, deflating disposable personal income available to spend on goods and services, and capital gains on the "total returns" side, so as to show how most wealth is achieved not by actual production but by increasingly debt-financed asset-price inflation.

Debt-Financed Asset-Price Inflation as Finance Capitalism's defining dynamic

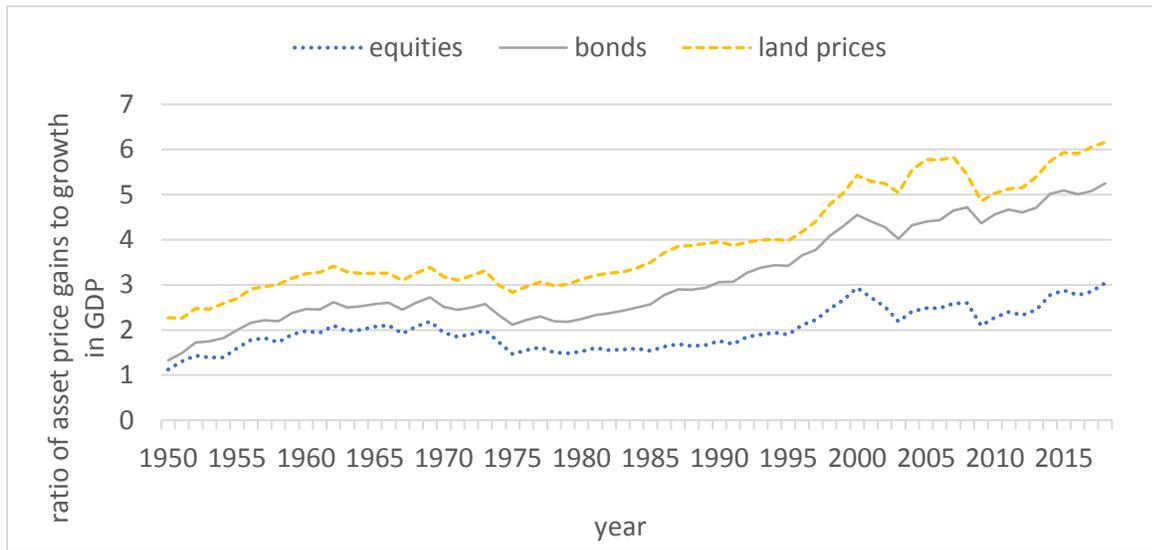
To explain the economy's polarization and the dangerous debt corner into which the economy has painted itself, we show that the industrial production-and-consumption economy described in the National Income and Product Accounts (NIPA) takes a back seat to the financialized balance-sheet economy of wealth, borrowing and speculation. Figure 1 charts the annual change in land valuations (as reported by the Federal Reserve's Flow of Funds report), bond and stock market gains or losses compared to annual changes in GDP. In almost every year, asset-price gains in the real estate and capital markets far outpace the gains (or shrinkage) in reported GDP. And when land prices plunged in 2008 as a result of the banking system's bad loans, this caused a stock-market plunge and GDP decline. That means that only a small proportion of wealth, measured in financial market terms, results from actual production or from savings out of wages and profits in the production-and-consumption economy (Chart 2).

Figure 1: year-on-year changes in GDP and asset price gains (nominal, \$bn)



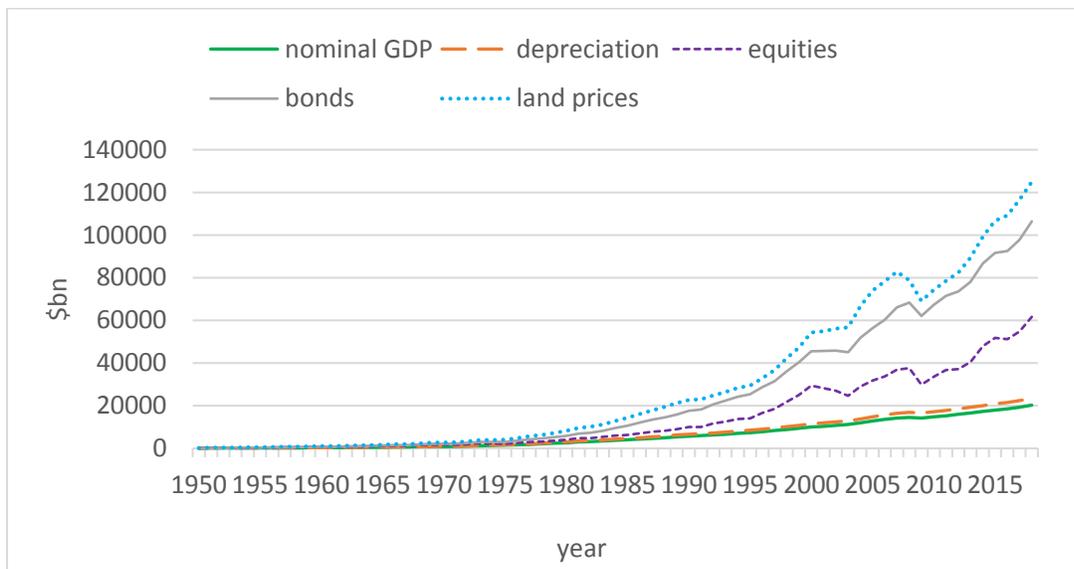
Source: Federal Reserve's Flow of Funds

Figure 2: Asset price gains as multiples of growth in GDP, 1950-2018



Source: Federal Reserve's Flow of Funds.

Figure 3. Cumulative total returns: the sum of GDP, equities, bonds, land values and depreciation, 1950-2018 (nominal, \$bn)



Source: Federal Reserve's Flow of Funds

This financial reality of how the U.S. economy works is no longer captured in GDP statistics. That is why in this paper we will introduce a *total returns measure*: income plus capital gains (Chart 3). Studying the distribution of total returns tells us more about polarization in America than the official statistics. The landlord class discussed by Classical economists has now evolved into a financial class. These two charts show the extent to which finance capitalism has overtaken what was expected to be the trends of industrial capitalism.

From the United States to Europe, middle-class families have seen their net worth rise mainly because of the price of their homes, not through income saved out of their wages and salaries. The tendency is to believe that this asset-price inflation makes them and the economy richer, overlooking how it leaves them and the economy more debt-strapped. The vast majority of asset-price gains since the 2008 crash have accrued to the wealthiest holders of financial assets, to whom the rest of the economy is indebted.

The magnitude of “total returns” as compared to GDP, and their concentration in the hands of the wealthiest 10 per cent, has become the distinguishing feature of today’s finance capitalism. Rising asset valuations go hand in hand with the economy’s increasing focus on extraction of economic rent (discussed below). This is the opposite of what classical free market reformers hoped would be (and indeed, what seemed to be) the political dynamic of industrial capitalism in the 19th century. We explain the rising role of *rentier* income by isolating this rent, above all in the Finance, Insurance and Real Estate (FIRE) sector.

The creation and trading of property and financial assets at rising prices has been fueled by rising debt levels owed to the financial sector. The primary market for today’s commercial and central banking, especially since 2008, has been to fuel capital gains by more credit/debt creation.

The question is, does this credit actually add to GDP? Is it an intrinsic part of the production process? If we recognize debt creation as being external to production and consumption, then the financial sector’s returns are a subtrahend. Income accruing to the financial wealth owned by the top 10 Percent is paid mainly by the bottom 90 Percent in the form of rising debt service and other returns to financial and other property.

In the textbook models of industrial capitalism’s mass production and consumption, an asset’s price is determined by its cost of production. If the price rises above this level, competitors will offer it

at cost, keeping prices in line with actual value, that is, the necessary cost of production. But in financialized economies, an asset's price is determined by how much credit buyers can borrow to buy it. A home is worth as much as a bank will lend to a bidder, not limited by its cost of production. Furthermore, this bank mortgage lending and hence the price of housing has tended to run far ahead of actual rent levels.

The engine of industrial capitalism and its consumer society was a positive feedback loop in which widely shared income growth, expanding consumption and markets generated yet more investment and growth. By contrast, the feedback loop of financial capitalism is an exponential growth of debt, driving up asset prices and hence requiring yet more borrowing to buy homes, retirement income and other assets. This dynamic extracts interest and amortization from the economy, shrinking markets for real output.

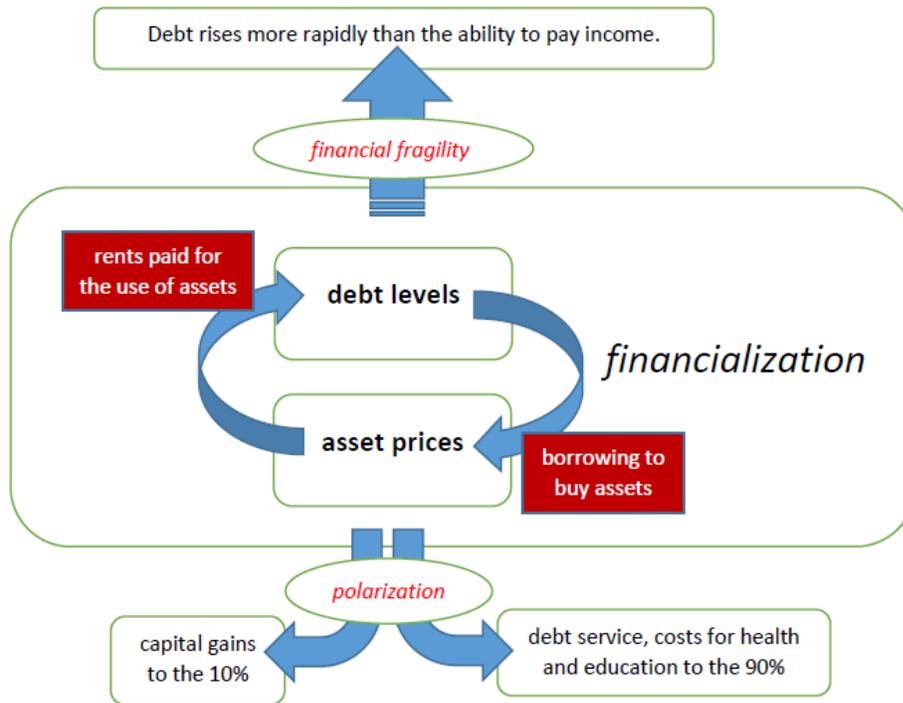
Corporate management and investment today is more about obtaining capital gains for real estate, stocks and bonds than about earning income. We illustrate this by charting the flow of income and capital gains in the real estate sector to show the dominance of asset-price gains over net rental income – and how rent is for paying interest in our financialized economy. Likewise, corporate income is spent (and new debt taken on) largely for stock buybacks to raise share prices. The resulting dynamic is exponential and destabilizing.

Our conceptual framework to chart the course of today's financial capitalism shows that the magnitude of changes in asset values and debt levels far overshadows the National income and Product Accounts (NIPA) framework that provided the statistics for industrial capitalism's production and real investment. The drive to make wealth purely by balance-sheet asset values and rent extraction eats into the circular flow of production and consumption. That has two consequences, indicated in red in Figure 3.

The first dynamic at work is the tendency for the volume of debt to increase faster than income. This increases *financial fragility* as debt/income ratios rise in order to keep up with debt-inflated asset prices. At first, rising debt service is paid out of capital gains – for instance, by homeowners taking out home equity loans (second mortgages) to carry this bank debt. That is the Ponzi scheme character at work. That makes today's financialized growth model unsustainable, because in the end many debts cannot be paid. *Trying* to pay them leaves less and less disposable personal income

available to spend on goods and services. At some point a crisis is triggered as the economy shrinks, people lose their jobs, and loan defaults rise.

Figure 4: *Financialization in America: two consequences*



We thus face a stark choice: either debt write-downs followed by renewed and more equitable income growth; or continuing wealth concentration, accelerating debt growth, widespread foreclosures and another crash. This choice can be postponed, but it cannot be avoided. The longer a debt writedown is postponed, the more the economy will slow down and the more massive and painful the ultimate crisis must be. As long as the debt overhead continues to grow, it will produce pathologies in the economy and in society.

The major pathology is the second dynamic of financialized capitalism: *economic polarization* between creditors and asset-owners at the top, and debtors at the bottom. The post-2008 financial wave has created unprecedented new fortunes for the 10 Percent, but this *rentier* ‘growth’ model is destabilizing the rest of the economy, not enriching it. Since the 2007 crisis this dynamic has produced capital gains for the richest 10 percent of Americans, but is eating into the disposable spendable incomes of the bottom 90 percent. The Obama “hope and change” program turned out to benefit Wall Street, not the rest of the economy. By keeping the existing debts in place instead

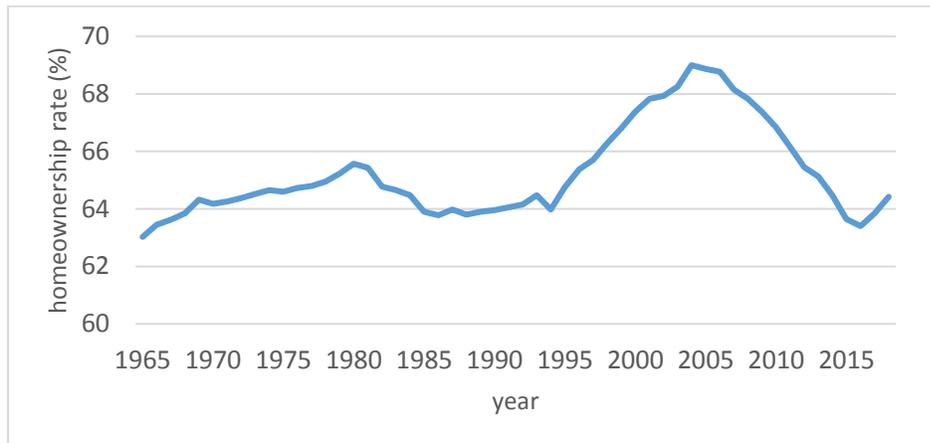
of writing them down, and by deeming the largest Wall Street institutions “banks” classified as “Too Big to Fail/Jail” (TBTF/J), the U.S. economy was sacrificed to the political system’s largest campaign contributors (the Donor Class).

Before being able to buy the products that they produce, wage-earners must use their after-tax income to pay for housing, debt service on their credit cards and automobile or other debts, compulsory health insurance and medical care via HMOs (“Obamacare”), education and student debt, and basic utilities taken “off the top” of their paychecks each month. These *rentier* charges drain income from households and firms in the “real” production-and-consumption sector to asset owners and creditors in the financial sector.

Falling interest rates since the 1980s (reduced to near-zero in the last decade) have kept these payments smaller than they normally would have been. Central banks in the United States and Europe have lowered rates specifically to enable the debt overhead to be carried, and hence to avoid default, and indeed to fuel what Treasury Secretary Tim Geithner called “foaming the runway” for the enormous post-2008 debt takeoff. The resulting financially engineered boom in asset prices and capital gains has enriched bondholders and stockholders. Inasmuch as asset ownership is highly concentrated, this financialized boom has widened the gap between income inequality and wealth disparities.

The American economy therefore has painted itself into a corner. Low interest rates have kept the bond market and banks solvent with a high tide of new corporate, personal and government debt, but much of the “real” economy is falling into arrears in the face of the exponential debt wave. Home ownership rates have fallen (Chart 5) as properties have been foreclosed by creditors and sold to new institutional investors such as Blackstone in the booming residential rental market.

Regeneration of the socio-economic system on a more equitable and sustainable basis requires that the economy break free from this policy. The first step to create support for “de-financialization” must be to create awareness of how the dynamics and character of today’s finance capitalism are polarizing the economy and making it more fragile, leaving people more insecure. Their emotional suffering is best understood in terms of the financial and macroeconomic strains that are shaping their psychological condition and making them fearful of losing their middle-class status.

Figure 5: Homeownership rate (percent)

Source: U.S. Census

Section 2 - The case for adding balance-sheet “capital” gains to national income

To recognize that wealth is accumulated more by capital gains than by saving out of current income, we introduce a new measure: adding capital gains to “earned” income provides a measure of the economy’s *total returns*. That is what most investors and corporate managers aim for in today’s age of financialization. To bring out the financialized nature of capitalism, we view the whole economy as if it were a financial investment.

Balance-sheet relations, headed by credit and debt leveraging as well as tax policies (untaxing income from wealth and shifting the fiscal burden at the federal, state and local levels onto labor and industry) far outweigh current earnings. That explains why corporations use their revenue for stock buybacks and dividend payouts instead of undertaking new direct investment and hiring. It also explains why real estate investors are willing to pay most of their rental income to the banks as interest on the loans they take out to buy properties. Their focus is not on net income, but on the prospect of achieving a capital gain on the sale of the property at a higher price. By analyzing the economy from their viewpoint, we will better understand the post-industrial logic that drives the system today.

What FIRE-sector lobbyists have persuaded national income statisticians to report as “earnings” – and corresponding “output” – is not really earned, but is more in the character of a free-lunch rake-

off, or rents'. The GDP framework was more fitting for the age of industrial capitalism than for today's financial capitalism.

The circular flow of production costs, consumption, saving and taxes

Today's basic System of National Accounts was created in the 1930s to focus on the cost of production and how these costs – wages to labor, payments to suppliers, business profits and taxes paid to the government – are distributed and, in turn, spent on consumption, new capital investment and public programs. The resulting measure of economic activity is the Gross Domestic Product (GDP), defined as the sum of all earned incomes (wages and profit), juxtaposed to the output produced by labor and capital. This accounting format reflects a somewhat propagandistic post-classical view of how industrial capitalism is supposed to work efficiently. All returns are depicted as “earnings,” even including economic rents not earned by work, innovation or entrepreneurship in the production process.

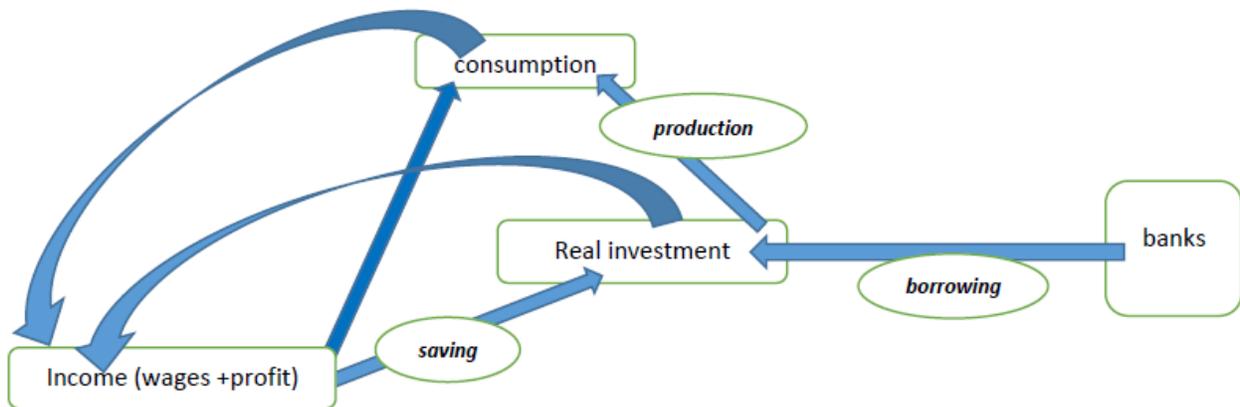
The original national accounting principle of circular flow can be traced back to the 18th-century French Physiocrats. Their aim was to quantify how large the economic surplus was and how it was distributed, not only among producers (labor and capital) but also to landlords, the major *rentiers* of the preindustrial epoch. The political aim was to make land rent France's tax base, freeing labor and industry from the costs of supporting its hereditary landlord nobility whose conquest imposed land rents as a form of tribute. Earlier, John Locke also had said that taxes should fall on the landlord class, because that is where the national economic surplus was concentrated. And classical economics and tax theory focused on who ended up with the economic surplus. “It is vain in a country whose great fund is land to hope to lay the publick charge on anything else; there at last it will terminate.”⁴

Adam Smith and subsequent British economists adopted this idea as the basic element of classical value and price theory, isolating land rent and other forms of economic rent as the ideal tax base, and freeing labor and capital from high taxes and prices for food, housing and other basic needs.

⁴ John Locke, *Some Considerations of the Consequences of the Lowering of Interest and the Raising the Value of Money*, In Works, Fifth ed., 1768, Vol. II. p. 35. (= Works, 1824, Vol. IV, p. 60).

By the 1930s an anti-classical revolution had taken place, asserting that all income was earned, not unearned or predatory. Meanwhile, Joseph Schumpeter's *Theory of Economic Development* expanded the view of circular flow between income and production expenditures to include banks. They were assumed to support investment and innovation by creating credit, while individual "households," partnerships and corporations invest in financial markets. In this view, production expands by mobilizing more resources and raising their productivity, enabling consumer spending to rise. Schumpeter recognized that lending also occurred for consumption and speculation, but such "unproductive lending" was outside of his focus on economic development.

Figure 6: The circular flow of the real economy



John Maynard Keynes and Michal Kalecki emphasized how new capital investment was dependent on rising wage income to enable consumers to buy what was being produced. Figure 6 depicts this circular flow. Its curved arrows reflect the hypothetical equality (by definition) between investment plus consumption with the wage and profit earnings that are at the heart of this model. In contrast to classical French and British political economy, their models of the industrial economy depicted all returns as incomes, taken as wages or profits. And like Schumpeter, Keynes and Kalecki emphasized how bank credit augmented the circular flow between consumption and investment. Banks were recognized only as supplying money to producers (and to consumers). On balance, they were not supposed to drain it out of the production and consumption processes. Keynes in particular recognized that this picture was incomplete and that *rentiers* undermined the economy's circular flow. Yet despite calling for the 'euthanasia of the *rentier*,' he did not assign them a central place in his theory.

The circular-flow approach formed the basis for Simon Kuznets to develop what has become the dominant GDP model. Government spending on military and other sectors was seen to generate incomes without producing consumer goods. As military spending rose in response to World War II, its role was measured in order to focus on the disparity between income and production. His GDP framework was developed as a policy tool during World War II to keep incomes in line with the production of consumer goods, so as to control inflation.

Economic rents and “capital gains” as returns beyond “earnings”

The national accounts bequeathed to us by Kuznets and his followers miss the two most important characteristics of finance capitalism. As noted above, the NIPA do not show how owners of rent-yielding assets benefit from “capital gains” as market prices rise for real estate, financial securities (stocks and bonds), property or patent rights. We put “capital gains” in quotation marks because rent-yielding assets and their asset-price gains are not capital in the sense of industrial capital – a factory, tools, R&D or other actual means of production.

Also, in terms of the current flow of income, economic rent is not isolated in the NIPA’s breakdown of GDP. Such rent is the blind spot of today’s macroeconomics. It is a category of income and increase in wealth that does not involve work or production, but is simply the yield of a property right, legal privilege or “patent” to receive income from users of assets that are owned or patented. So rent has no corresponding product. It is a subtrahend, an economic overhead.

Concern over rising land rent and the resulting land-price gains was central to classical economics. The quintessential *rentiers* were the landowners. It was recognized that land rents tend to rise over time in the normal course of things. John Stuart Mill described how a landlord enjoys such rising rents and asset-price gains “in his sleep”:

“The ordinary progress of a society which increases in wealth, is at all times tending to augment the incomes of landlords; to give them both a greater amount and a greater proportion of the wealth of the community, independently of any trouble or outlay incurred by themselves. They grow richer, as it were in their sleep, without working, risking, or economizing. What claim have they, on the general principle of social justice, to this accession of riches? In what would they have been wronged if society had, from the beginning,

reserved the right of taxing the spontaneous increase of rent, to the highest amount required by financial exigencies?”⁵

If Mill had called landlords the One Percent we would immediately recognize the similarity to today’s rent extraction. The One Percent, and even the Ten Percent, are the asset-owning class corresponding to the 19th century’s hereditary landed aristocracy and its groundrents. Today, they are the major designers and gainers from financialization, “without working, risking, or economizing.” By imposing tollbooth monopoly charges that siphon off income from the production-and-consumption economy, their windfall *rentier* gains render the economy more polarized and fragile.

As noted above, the political attempt to free economies from such rent seeking inspired the inception of national income accounting in the mid-18th century by the Physiocrats. By measuring the economic surplus, which they saw as generated exclusively on the land, they sought to tax the post-feudal landed nobility instead of labor and industry. Francois Quesnay, a surgeon to the king of France, applied to the body politick the idea of the circular flow of blood within the human body. At the hands of Adam Smith, David Ricardo, John Stuart Mill and the reformers in their train, British political economy defined a free market as one freed from the rents siphoned off by landlords, monopolists, banks and other financial institutions from the rest of the economy, including industry and commerce as well as agriculture.

The late 20th century saw landlords and bankers fight to reverse this basic political aim of classical economics. Instead of making *rentier* income the tax base, they sought to *untax* it. To defend their anti-classical revolution, they re-defined a free market as one free *for* rent-seekers to keep for themselves land rent and monopoly rent. Bankers were given tax favoritism for investors buying rent-yielding properties on credit and paying their rent to creditors as tax-deductible interest. To defend their position, they changed the conceptual framework of national income and product accounting, rejecting the distinction between income earned in the form of wages and profits as compared to economic rent and balance-sheet gains in asset prices.

⁵ Mill, John Stuart (1848): *Principles of Political Economy, with some of their Applications to Social Philosophy*, Book V, ch. II §5.

In reality, wages and profits are only two forms of revenue and the means to obtain wealth. Since the 1980s, economic rents and asset-price gains for rent-yielding assets have become the major ways in which wealth has increased, not industrial investment and earnings. Owners of property receive passive (*rentier*) income and capital gains on the rising market valuation of their real estate, stocks and bonds. But the purpose of the National Income and Product Accounts (NIPA) inspired by the circular-flow framework is neither to measure asset-price gains, nor to draw the classical distinction between earned and unearned income by juxtaposing wages and profits to economic rents from land ownership, monopoly privileges and patents, and finance capital.

Section 3 - A new framework: subtract rental and financial “services” from the NIPA as non-products

Every statistical framework is based on some implicit economic theory. Mainstream textbooks, most journal articles and policy advice euphemize all rental income as “earnings.” *Rentiers* and their lobbyists insist that all charges for access to credit, health care, education, utilities, insurance, and housing are justifiable and productive costs of doing business for the use of bank credit-creating privileges and loans, insurance policies, real estate, drug patents, schools and power and water grids. The effect of the NIPA system of national accounts (rooted in the anti-classical reaction of J. B. Clark in the 1890s) is to leave the public with an impression that unearned rents simply do not exist – as if all non-wage income is profit, and as if everyone “earns” whatever they can take, regardless of how they obtain it.

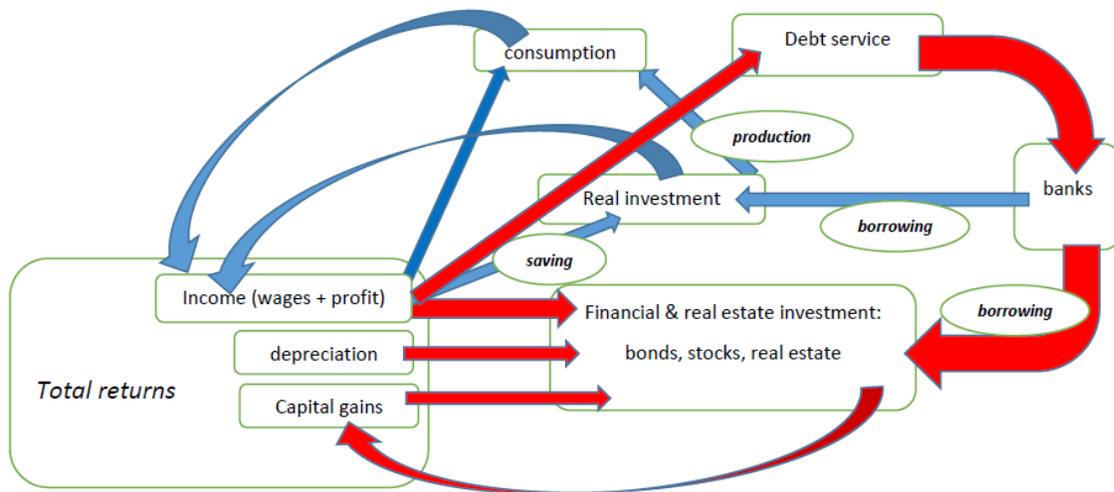
To measure the magnitude of rent, and to build a statistical framework relevant to today’s financialized economy, we need to draw on the classical tradition by recovering the vocabulary that it developed precisely to create a conceptual framework to measure rent extraction. Only when we statistically identify it can we analyze its role in polarizing today’s economies by causing “*rentier* austerity” “or “rent deflation” for the production-and-consumption economy.

The GDP framework of the circular flow of goods and money in the real economy has become intellectually obsolete largely because financialization of real estate, stock and bond markets has created two new types of return that are not reported as “earnings”: depreciation and capital gains. Figure 7 shows the extent to which corporate cash flow – profit and depreciation – plus new

borrowing considerably exceeds new investment, and thus has become decoupled from real investment as compared to the pre-financialization era before the 1980s.

Landlords charge rent for their housing and commercial real estate. Homeowners keep the rising rental value of their homes for themselves. Banks create credit, enabling buyers to purchase such properties. The more they lend, the higher prices rise for these rent-yielding assets – financed on credit, with the rental value paid to the banks in exchange for loans to buy homes before rents and housing prices rise yet further.

Figure 7: The FIRE sector's intrusion into the economy's circular flow



Some rate of return is necessary to motivate investment, maintain real estate, power grids and factories, and undertake private-sector research to produce new drugs. But pharmaceutical companies price their drugs on which they own patents at whatever the market will bear, without reference to actual costs of production. A century ago, rates of return were publicly regulated, as were interest rates by usury laws. Rates of return for utility companies supplying gas and electricity are still regulated, but not water companies.

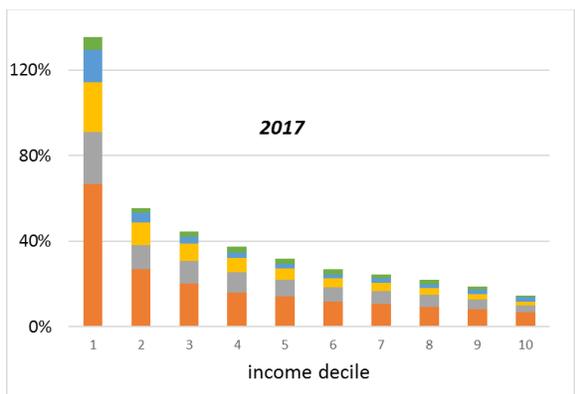
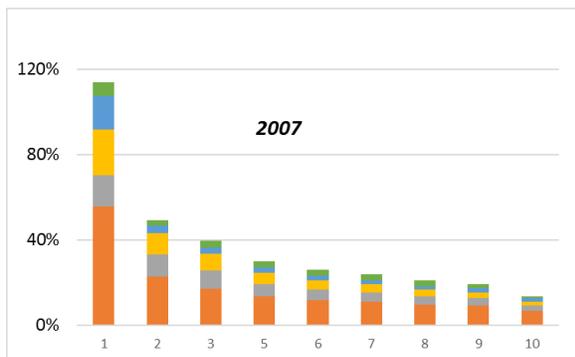
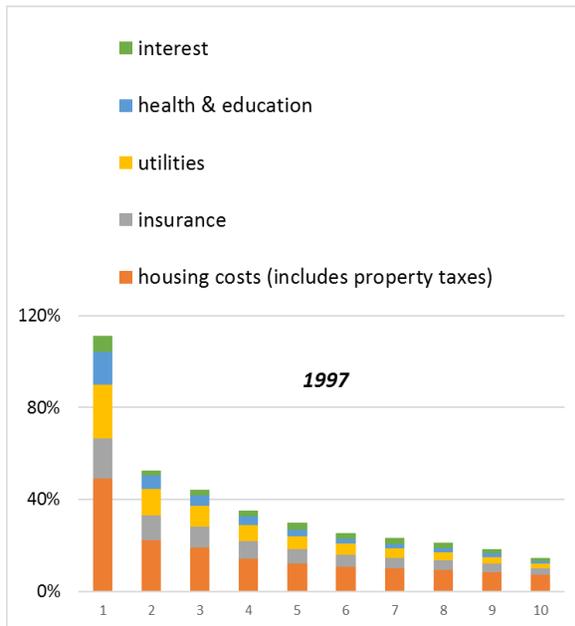
It was an article of faith in progressive industrial economies such as the United States and Germany that governments should prevent monopoly pricing for basic infrastructure, and indeed to supply basic needs at subsidized prices or freely: health care, water, communications, education and transportation, and also money and banking services. Progressive income taxation was to fall mainly on landlords, monopolies, banks and their owners (“coupon clippers”).

Classical economists deemed legal privileges unproductive to the extent that they enable their owners to charge users of these assets more than what is needed to provide and maintain their services. They drew a clear distinction between costs of production that are economically necessary, and rent charges that are not necessary and therefore are a net burden on the rest of the economy.

Land sites, for instance, are provided by nature, while their use-value is a product of public investment in local infrastructure and the level of prosperity. Monopoly privileges for banks and basic infrastructure also are created by lawmakers “by the stroke of a pen.” Payments to owners of these privileges - privatized and financialized into legal assets – are largely a burden on society’s incomes, not an investment in the economy’s capacity to generate real output. The income they redistribute as rents to the owners of these rights and privileges, are subtracted from incomes in the lower brackets of the distribution.

Unlike paying wages or payments for materials and professional services for production and distribution, rents are zero-sum transfer payments with no real *quid pro quo*. That is why payments for land rent, monopoly rent and financial charges should not be counted as part of the economy’s “product.” No value added is realized from paying such rents, so national income does not grow as a result. Such charges and fees are a pure *transfer payment* redistributing income from renters or users to *rentier* owners. They are not costs that need to be incurred in order for the productive process to continue. They are best thought of as tolls imposed at the economy’s choke points, access charges independent of necessary production costs. These costs are paid by users, and become windfall gain for *rentiers*, accruing without any productive effort of their own, as Mill and his fellow classical economists emphasized. Such rents do not reimburse the cost of investment to create these assets (land sites or exclusive patent rights), but burden the cost of living and doing business by being superimposed on the economy’s production and consumption costs. Their reduction or full removal therefore will not harm production or consumption levels.

Figure 8: The share of economic rents in pre-tax incomes over income deciles



Note: These charts do not include taxes and FICA tax withholding (Social Security and Medicare deductions)

Figure 8 is our suggestion for how to measure these rents. There are numerous ways to do so, because the distinction between rent and other forms of income rests on how the distinction is drawn between returns that are productive, adding value and “product” to the economy, and returns that result simply from ownership rights and hence do not really reflect a “product” but merely detract from the economy’s income. This distinction ultimately is political, as was Kuznets’s politically expedient decision to include military expenditure as productive.

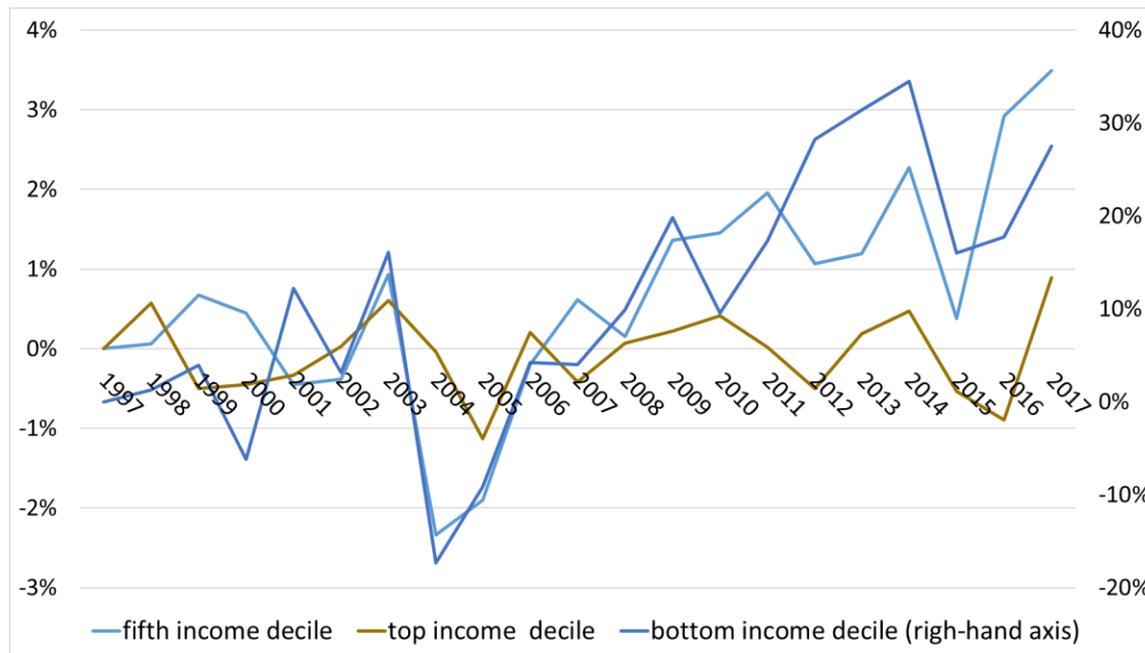
To show how regressive and extractive such *rentier* charges are, Figure 7 deducts them from after-tax incomes for each of the ten income deciles for 1997, 2007 and 2017. Hardly by surprise, the lower income brackets pay the highest proportion of their income for access to housing, education and other necessities – let alone to maintain consumption. For the lowest income decile, these deductions are more than 100 percent of income. The poorest 10 percent receive public subsidy in addition to their reported income. Still, they are obliged to pay a higher percentage of their income as interest, especially because they are more driven to resort to usurious payday loan sharks as well as having to pay higher penalty interest rates on their credit cards.

A second noteworthy trend is that for the bottom 30 percent, total subtractions rose as a share of income *after* the 2007 crisis. And in fact, most likely these Federal Reserve figures substantially understate the housing burden for most people. Housing costs are about 15 percent on average for the bottom 50 percent. But private studies and media reports show that housing costs have risen much more than incomes, absorbing a larger and larger proportion each decade. The fact that the U.S. Government (FHA, Fannie Mae, etc.) guarantee personal home mortgages absorbing up to 43 percent of an applicant’s income gives an idea of the proportion of income that many home buyers have to pay. The BLS, Consumer Expenditure Survey Public-Use Microdata 1996-2014 reports that households in the Lower Third spent 40 percent of their income on housing – and renters nearly half (as of 2014).⁶

⁶ See for instance <https://www.governing.com/gov-data/economy-finance/housing-affordability-by-city-income-rental-costs.html>, Housing Affordability Burden For U.S. Cities, and Shawn M. Carter, “The top 10 US cities where rents have increased the most,” CNBC, , January 4, 2019 <https://www.cnbc.com/2019/01/04/the-top-10-us-cities-where-rents-have-increased-the-most.html>

This suggests that something is seriously wrong with the Fed’s statistics. Given this anecdotal empirical evidence, these charts based on official statistics are only a very conservative estimate of the extent of inequality in the distribution of the burden of subtractions from pre-tax incomes that is due to the FIRE sector and kindred monopolies. The official statistical methodology has, by implying that the FIRE-sector deductions have barely risen as a proportion of GDP for every income decile from 1998 to 2007 to 2016, has become far removed from financial reality.

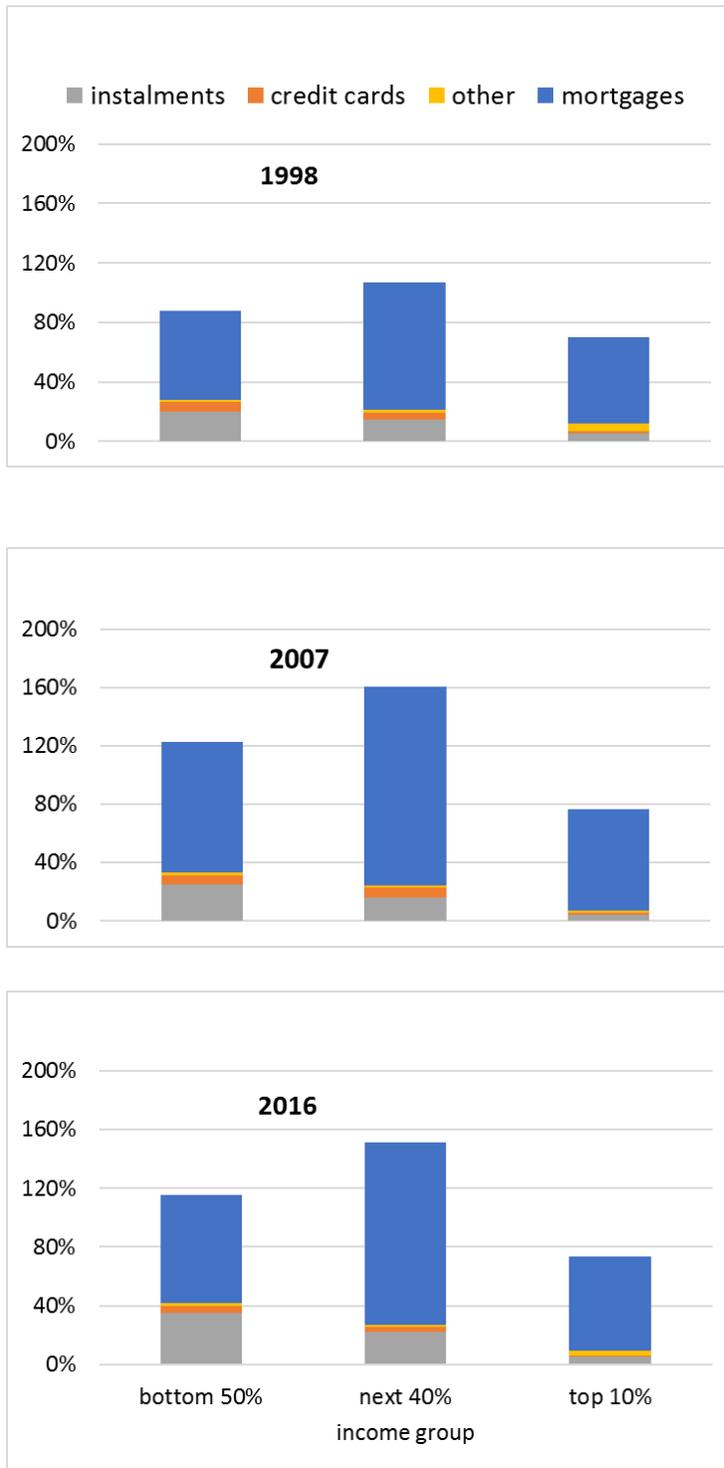
Figure 9: Change in rentier deductions, as percent of income:



Source: Survey of Consumer Finances

For the moment, the official statistics are all we have, and the trends they show are already bad enough. Figure 9 shows the change in *rentier* deductions as a percentage of income over two decades. No change occurred for the top decile, but for the middle decile it rose from the mid-2000s to 3 percent in 2017 and at a rate *ten times* larger for the bottom decile, to 20-30 percent.

Figure 10: holdings of debt as percentage of income: the debt burden (percent income) has risen for the 90 percent, but not for the 10 percent



Source: Survey of Consumer Finances

These distribution charts show that after the 2008 crisis, rental privileges remained the prime category of asset ownership. It therefore is necessary to measure the extent to which such rent-seeking is superimposed on today's post-industrial economy, eating into the circular flow of production and consumption spending.

Depreciation as a rentier overhead

Nowhere is the NIPA's divergence from reality more visible than in the treatment of depreciation, specifically for the real estate sector which the Internal Revenue Service has estimated accounts for some 80 percent of reported depreciation.⁷ There are two sources of statistics on real estate depreciation, and each source has quite different aims. That of the IRS is to measure the actual flow of income within the economy, and to apply the tax law to this income. Over the years, lobbyists for the real estate sector and its financial backers have created a widening divergence between the picture produced by tax filings and that which the NIPA report in measuring "real" product and its income flows. The NIPA's reported picture of reality does not reflect why Donald Trump said that he loved depreciation, because it enabled his accountants to show a book loss instead of taxable income. By trying to depict physical reality rather than the actual financial income flows, the NIPA statistics overlook the financial reality of how investors use various pretenses that the tax code permits absentee owners of real estate (but not homeowners) to use.

Depreciation is revenue that is supposed to reflect the rate at which a building, factory or capital good wears out or becomes obsolete. The logic in making this revenue tax-exempt is to enable investors to recoup their original investment, as distinct from profits or rents *on* this investment. But do buildings really wear out? And if they do wear out, whether at the assumed rate of anywhere from 7 years (under the Reagan Administration's double declining balance method of calculating depreciation) or 30 years (the NIPA's "real" figure), why are so many buildings still standing that were built before 1990?

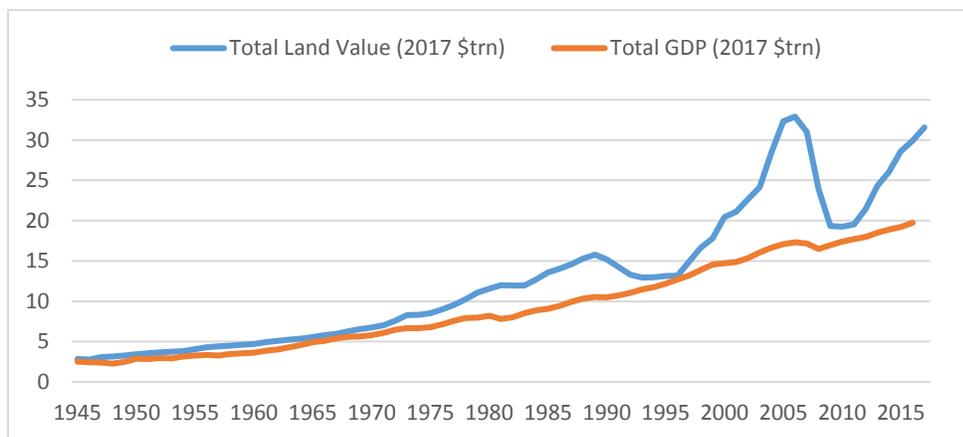
The answer, of course, is the rule of thumb that landlords typically spend about 10 percent of their rent roll on maintenance and repairs precisely to *prevent* buildings from wearing out and

⁷ The IRS's *Statistics on Income* is published every decade or so to provide benchmark data. That is the sole source of information on what real estate investors actually claim on their income-tax returns.

depreciating. But the NIPA – supported by Federal Reserve balance-sheet statistics in its quarterly Flow of Funds reports (Table Z) – show a deep confusion at work. Is it realistic for a building that has been depreciated and its value recaptured once, to be depreciated over and over again upon each sale, each time at rising prices? That is what the U.S. tax code permits. Each time a real estate property is sold, assessors attribute a portion of the price gain to the building, so that depreciation will rise with it.

A more realistic appraisal would be to assign this valuation to the land, not to the landlord’s capital investment in the building. The effect of this mis-attribution is to enable real estate investors to take most of their net rental income in the form of tax-exempt “depreciation.” *Over-depreciation* would be a more appropriate term.

Figure 11. Land Value compared to GDP Trends: 1945-2015



Source: NIPA

NIPA economists realize that the statistic they report for the real estate sector (Table 6.13D for partnerships and proprietorships, and 6.22D for corporate owners) is not the actual revenue accruing to real estate investors, but a *non-financial* imputation for how much the building “loses value” as a result of wear and tear or other depreciation (even as the property’s price soars!).⁸ This practice prevents a realistic estimate of how much money real estate investors actually are making tax-exempt, as Donald Trump has explained: “I appreciate depreciation. For me the relevant issue

⁸ The details are spelled out in https://apps.bea.gov/iTable/index_FA.cfm, esp. table 3.4ESI, and explained in <https://apps.bea.gov/national/pdf/chapter13.pdf>

isn't what I report on the bottom line, it's what I get to keep.”⁹ The fact that there seem to be no published statistics to measure this reflects the power of real estate and financial lobbyists to prevent popular awareness of just how large and egregious the false pretenses of over-depreciation really are.

Despite the steady rise in land prices (Figure 11) and hence building values, tax depreciation (and even NIPA calculations) imply that they are losing value. Real estate investors understandably do not want to publicize the extent to which their fortunes reflect these special breaks, based on fictitious assumptions favoring rent recipients at the expense of the tax collector. Depreciation has become a major category of real-life ebitda – earnings before interest, taxes, depreciation and amortization.

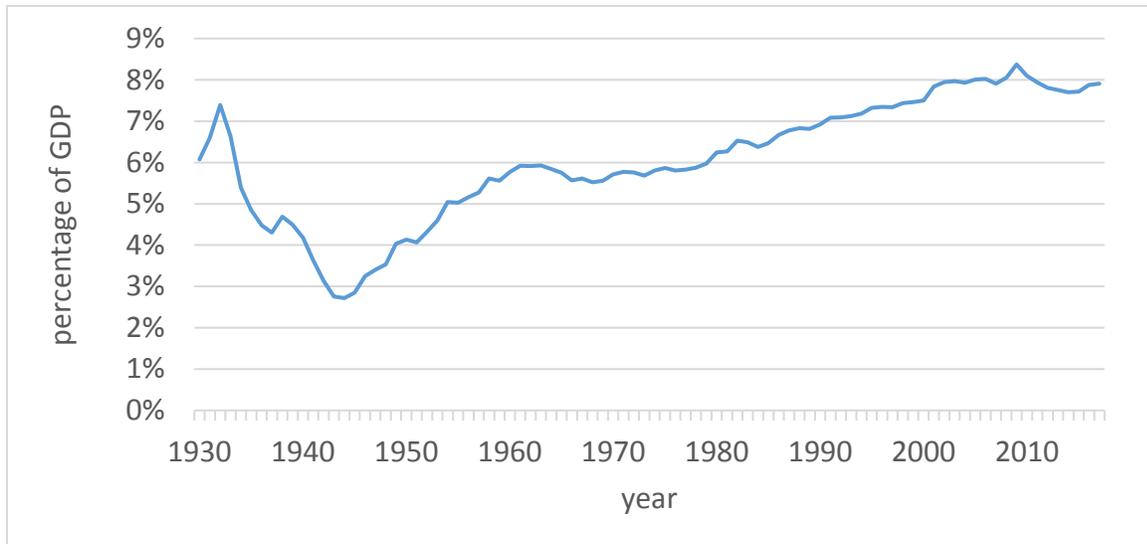
The effect of this tax “loophole” (that is, the pretense subsidized by political lobbyists) is to subsidize cash flow to fund new financial investment, helping asset prices rise. That has become the guiding logic of financial capitalism: to maximize financial flows into the real estate and financial markets, thereby creating a debt market. The “productivity” of debt is measured by its ability to increase asset price faster than the rise in debt, thereby increasing total returns. The problem for the economy at large is that this financial gain seeking drains revenue away from the circular flow of real investment and consumption instead of reinforcing it. The irony or “internal contradiction” is that what is financially remunerative (“productive”) tends to *impair* tangible capital formation and productivity in the “real” economy.

Homeowners' imputed rental value

In contrast to underreporting the depreciation revenue that absentee real estate investors receive tax-free, the NIPA add an estimate for “homeowners' implicit rent.” This is a “real estate service” that does not involve the economy's actual flow of spending and receipts. It is what homeowners estimate that they would have to pay themselves if they had to rent their home instead of owning it. This estimate accounts for some 8 percent of reported GDP (Chart 12).

Figure 12. Imputed rental value of owner-occupied housing as percentage of GDP

⁹ Quoted in Peter J. Reilly, “Donald Trump's Deep Love Of Tax Depreciation - An Affair To Remember,” *Forbes*, October 10, 2016.



Key to data sources used: NIPA Table 2.4.5, Line 52

This imputed rental value does not involve any actual payment or receipt of income. Is it even really a “product”? Rents have indeed increased sharply since the post-2007 wave of home foreclosures causing a nearly 10 percent decline in U.S. home ownership rates (from 69 percent to 64 percent; Figure 17. above, p.11) and declines in mortgage lending and new residential construction (except for the very high end).

According to the NIPA, the combination of housing shortage, rising home prices and corresponding increase in rents (charged to the one-third of the population that does not live in their own homes) means that homeowners who would receive exactly the same living environment as before should nonetheless be credited with receiving an increased “product.”

A realistic format to describe the economy would reflect how wealth is acquired increasingly by capital gains, not by saving out of profits and wages. But it is mixing “apples and oranges,” balance-sheet capital gains and the core economy of production and consumption to treat the imputed housing costs in the above chart as a “product” and hence contributing some 8 percent of GDP – and rising as America’s rent squeeze intensifies.¹⁰

¹⁰ The NIPA do publish a statistic for “real GDP” by deflating each year’s reported numbers with a statistic for price inflation (the GDP deflator, based largely on a selected consumer price index to reflect the cost of living).

Lobbyists for the FIRE sector have a vested interest in wrapping a cloak of invisibility around rent extraction and wealth created by financial instead of industrial engineering. They have played a major role in shaping the NIPA to conceal the magnitude of their rents by denying the classical contrast between earned and unearned income. To avoid being taxed, the FIRE sector, monopolists and other *rentiers* seek to distract attention from how they got wealthy by shifting the fiscal burden onto productive industry without playing a productive economic role themselves.

The working assumption (that is, the financial cover story) is that cash flow classified as depreciation will be reinvested, replacing depleted or obsolete capital stock. But after-tax profit far exceeds the private sector's tangible new capital formation. As noted above, the difference is explained by the fact that most cash flow is paid out as dividends or used for stock buyback programs.

Corporate borrowing and stock buybacks masquerading as supporting real investment

We can demonstrate the pretense that borrowing is financially necessary for real investment using the official data (Figure 13). After-tax earnings including depreciation almost coincided with investment until the mid-1990s, and hence was sufficient for this investment to take place. Borrowing therefore was not necessary for investment purposes. And except for a few exceptional recession years (1991, 2002 and 2009) when corporate cash flow fell so low as to be fully absorbed by investment, after-tax earnings and depreciation plus new borrowing were well in excess of real investment. Firms used this excess to pay their bond- and stock-holders, and to buy up their own stock to support its price – creating financial valuation without increasing production.

After 2002 a new financial boom started. Profits exceeded new investment by a wide margin, yet borrowing continued to rise unabated. Since 2000, its magnitude closely paralleled that of stock buyback programs (Figure 14). So in view of the fact that stock buybacks have accounted for the largest part of debt growth since the late 1990s, one could just as well say that firms use borrowing to buy back their own stocks as to say that they use their income for this purpose.

The upshot is that net U.S. saving is only a quarter of gross saving, with the difference accounted for by depreciation. It used to be half. There is still plenty of gross saving, but it is not being invested in tangible capital formation. It is used to buy assets – creating capital gains in the process.

Figure 13: Borrowing was not used for investment

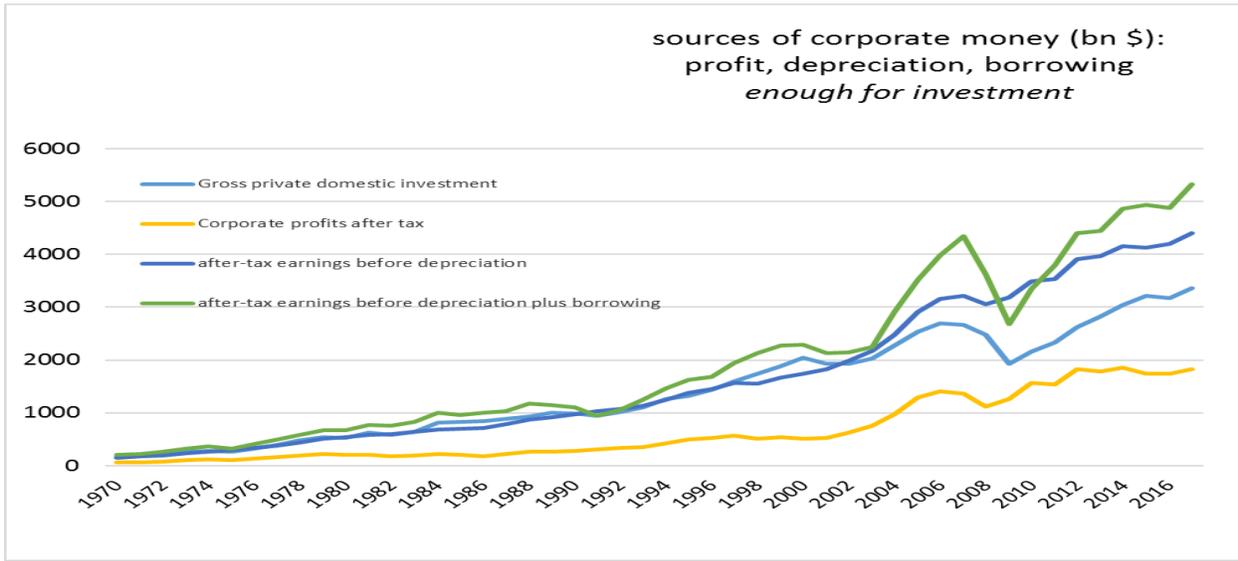
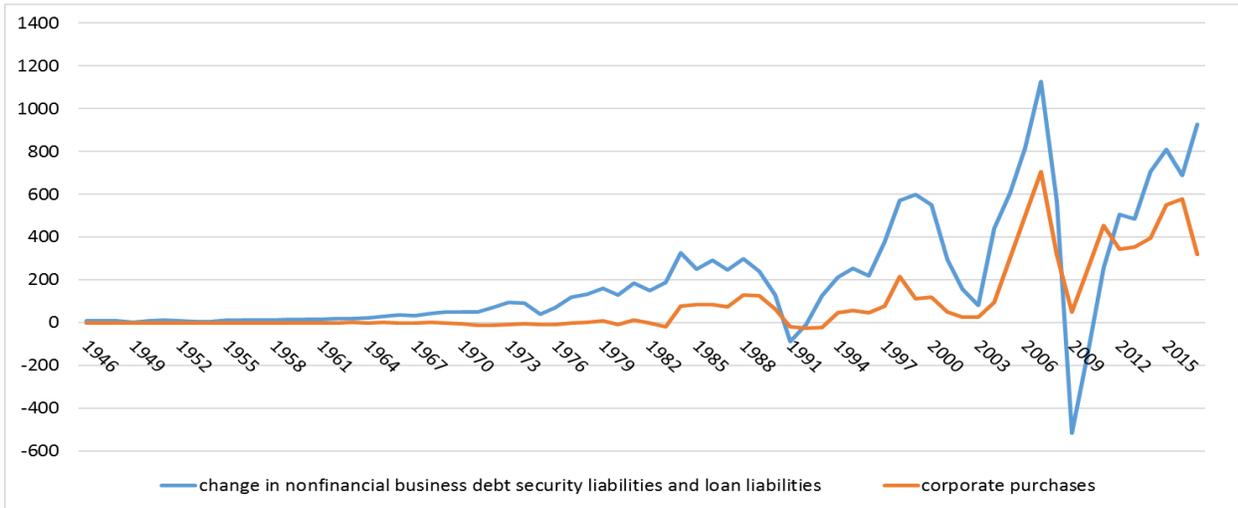


Figure 14: Stock buybacks track debt growth since the early 1980s



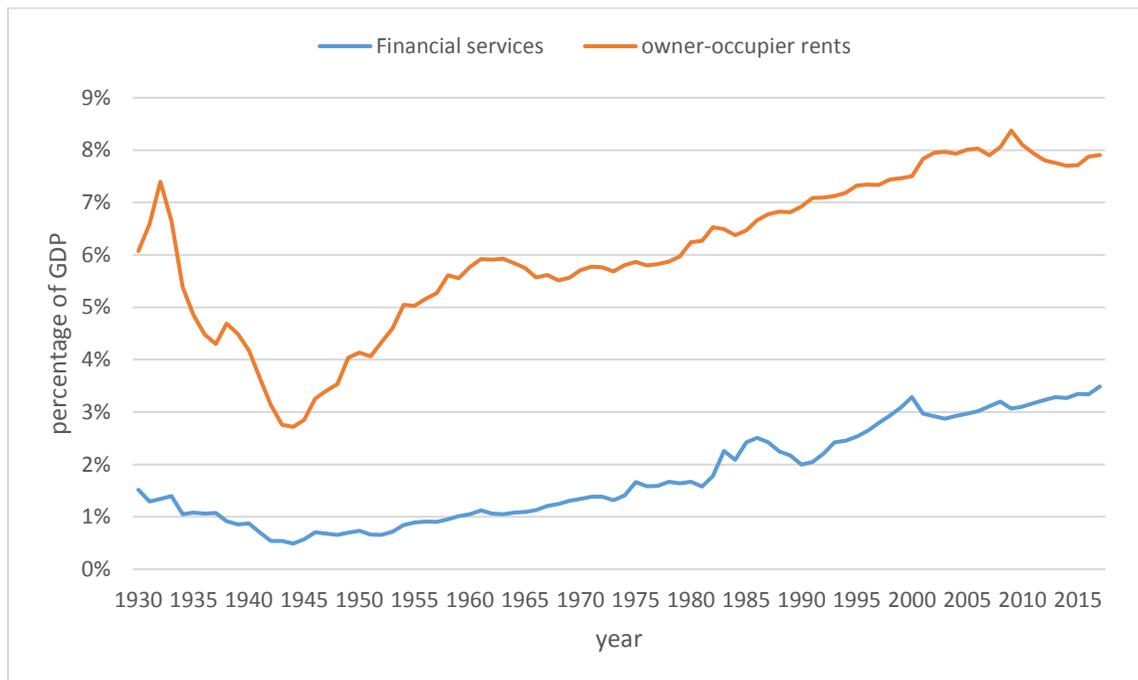
Source: NIPA

Imputations of hypothetical or fictitious “product”

The intellectual legacy of the GDP/NIPA accounting format has been distorted by including many lines that are the result of political lobbying. Our discussion of over-depreciation credits to the real estate sector shows the degree to which tax favoritism rests on economic pretense that the landlord’s rent is offset by a hypothetical physical deterioration of the building and hence a

financial loss. The tax code permits absentee real estate owners (but not homeowners) to pretend that their buildings (and “capital improvements”) are losing value, despite the fact that they rise in price over time, and also include much capitalized land valuation *as if* it was part of the building. Also, “imputed rent for homeowners” pretends that as home prices are inflated on credit and rents rise (along with mortgage debt), this adds to GDP. Chart 15 a third and equally egregious inclusion: “financial services”.

Figure 15. Imputed financial services and imputed owner-occupier rents as percent of GDP

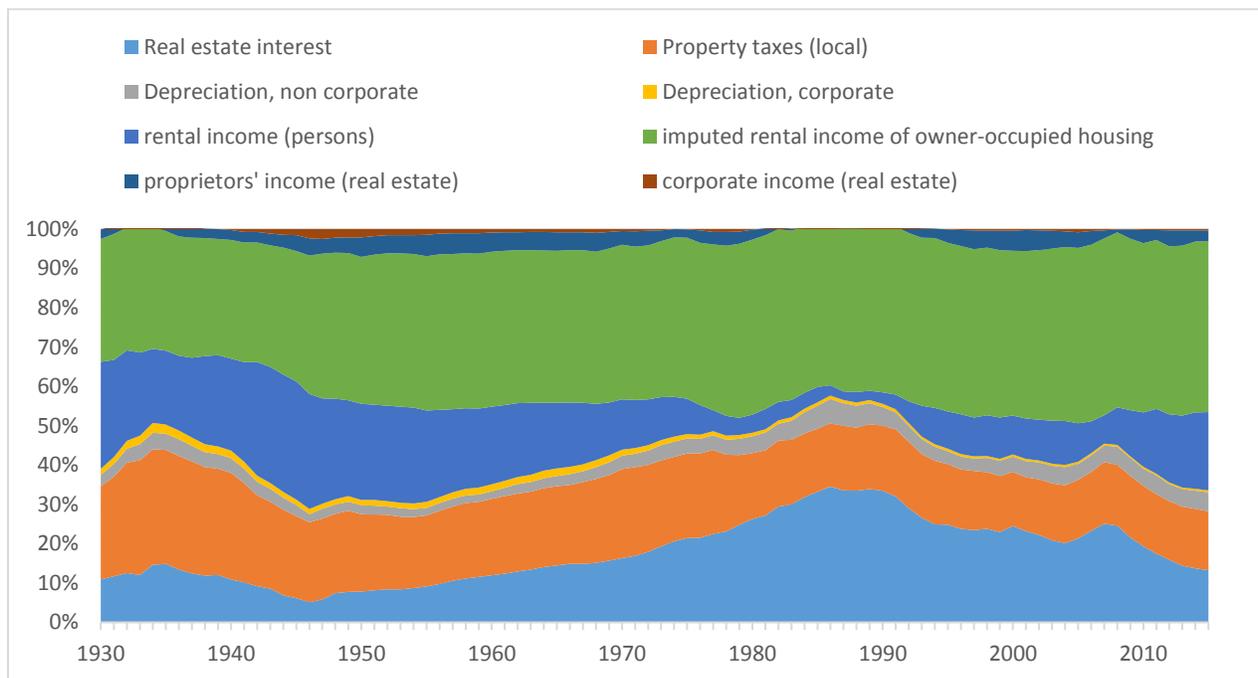


Source: NIPA

What has occurred is an inversion of values about the proper aim of economies. Today, it is to get rich by means of a financialized *rentier* economy. From the point of view of *rentiers* and other investors, the production-and-consumption economy is the overhead (Chart 18). The costs of labor and capital are to be minimized by squeezing out more economic rent. By contrast, our approach treats the production-and-consumption sector as primary, and the FIRE sector and other rent extracting sectors as overhead.

Supporting these rents and capital gains, the financial sector has grown increasingly dysfunctional. The increase in capital gains has been largely debt financed. Each debt is a credit on the other side of the balance sheet, because behind each borrower is a lender. The vast majority of new financial investment and bank loans are issued to acquire (that is, transfer ownership of) existing real estate assets, corporations and their stock. By driving up prices for these assets, this financial system causes home buyers to take on deeper debt levels. The effect is to divert more income to paying interest and much less for property taxes. Absentee landlords have paid scarcely any federal taxes, thanks to the tax-deductibility of what they report for interest and depreciation (Chart 16).

Figure 16. Composition of real estate ebitda, 1930-2015



Key: Variable definitions and notes as for Figure 15

Section 4 - From value-added to total returns

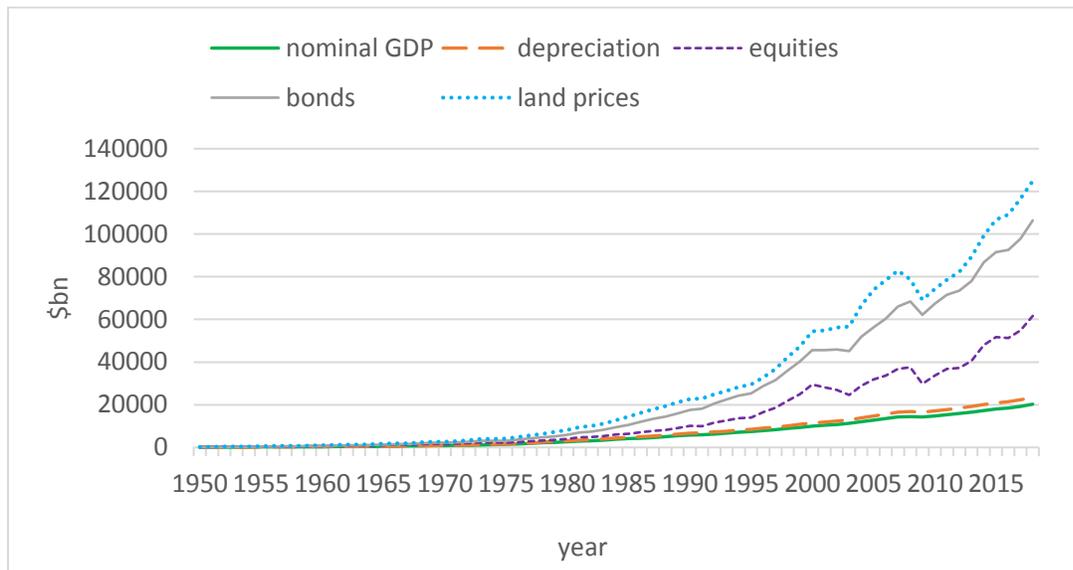
The statistical apparatus developed for industrial capitalism does not explain how the financialized aim is to increase market prices for wealth (real and financial assets) in ways external to the “real” industrial economy. To describe “total returns” beyond the categories of profits and wages, it is necessary to take capital gains into account, because they are the main aim of today’s financialized investment, and even of official policy. Taken together, bank credit, tax-free depreciation revenue, stock buyback programs and Federal Reserve Quantitative Easing have channeling liquidity into the financial and real estate markets to push up asset prices, creating capital gains for asset owners. Most of the beneficiaries are concentrated at the top of the economic pyramid, especially the top 10 percent, who recycle their gains as loans to the rest of the economy or spent on buying up more assets, with preference for those yielding economic rents.

Capital gains are today’s leading category of returns in financialized economies. To trace this distinguishing phenomenon of our era, a measure of total returns is necessary: earnings plus depreciation and interest (cash flow after taxes) plus capital gains. All these returns are have been financialized, creating a new circular flow of cash flow plus debt (credit), asset price-gains, and new financial investments and asset purchases, above all to rent-yielding sectors. This financial circuit cuts in to the “real” production-and-consumption economy’s circular flow. The rising debt overhead, coupled with tax favoritism for finance, makes real investment and consumption less liquid.

The term “ebitda” is often confusing to financial outsiders. It refers to total cash flow (“earnings,” including unearned economic rent) *before* subtracting interest, taxes, depreciation and amortization writeoffs. This jargon reflects the degree to which financial analysts recognize that cash flow is much larger than what the NIPA report. GDP includes accounting profit but not the depreciation that real estate owners claim on their tax returns and hence “get to keep,” in Donald Trump’s words. Depreciation is a large part of total returns in the real estate sector, where most of it is claimed in U.S. tax filings. It is rental revenue deemed tax exempt, a giveaway to Mr. Trump and other absentee owners.

Incorporating Total Returns into economic statistics tracing wealth disparities

Figure 16. Cumulative total returns: the sum of GDP, equities, bonds, land values and depreciation, 1950-2018 (nominal, \$bn)



Source: Federal Reserve's Flow of Funds

We are now in a position to integrate the preceding analysis into a macroeconomic measure to explain why financialized economies polarize and end up imposing financial and fiscal austerity. We find the standard practice of securities analysts to be appropriate: In addition to cash flow (ebitda) in the GDP “real economy” measure, we add in over-depreciation in real estate, and also capital gains so as to trace Total Returns. This is the best available measure to trace the sum of all income (GDP net of economic rent deemed to be merely a transfer payment) plus depreciation, plus price gains of the three largest assets classes: land value gains and capital gains on stocks and bonds.¹¹

Calculating total returns allows us to do what is not possible in the GDP-based production-focused system of national accounts. Bringing together income and changes in wealth enables us to explain today's widening disparities in the distribution of wealth and income by tracing the economy's actual gains (or losses) (Figure 16). To paraphrase hotelier Leona Helmsley, only the poor people

¹¹ We recognize that interest, dividends and new debt (mainly used for stock buybacks) may fall short of capital gains.

pay taxes and get GDP; the rich 10 percent, and especially the One Percent, get tax breaks and capital gains on their economic rents.

In our introductory summary, Fig. 3 has shown how wealth is made much more by making capital gains on real estate, stocks and bonds than by earning wages and profits. By 1982 the annual increase in market capitalization of the bond market overtook the annual GDP in magnitude. It has risen exponentially as the Federal Reserve has driven down interest rates, increasing the capitalized value of a given income. The widening polarization of income and wealth has been a deliberate policy. The Treasury has untaxed *rentier* and corporate income, showing special tax favoritism to real estate finance while the central bank has supported easy financing (with bailouts for banks making bad or outright fraudulent loans).

5. Conclusion: toward a more realistic profile of the financialized *rentier* economy

These figures provide the basis for a series of charts which visualize the economy's actual dynamic, to suggest entry points for policy interventions. The logic and policy values are basically those of 19th century classical political economy, above all by distinguishing the *rentier* economy from the production-and-consumption economy so as to distinguish rent from profits.

We draw on existing statistics to show that

(1) most wealth is achieved by asset-price gains for real estate, stocks and bonds, not by saving up earnings out of wages and profits;

(2) much of what are called “earnings” are actually economic rent – revenue that landlords, monopolists and banks charge, at prices that are unrelated to the cost of production process;

(3) banks and bondholders prefer rent-yielding assets precisely because they have no inherent cost of production. Land prices reflect the rent of location, bank credit is created simply on a computer keyboard (or as it used to be phrased, “by the stroke of a pen”);

(3) prices for *rentier* assets yielding these revenues are inflated largely by bank credit, indebting the new buyers. As credit terms are “loosened” by longer maturities, lower down payments and higher limits on debt/income ratios, bank credit tends to inflate asset prices;

(4) banks and bondholders recognize that whatever the tax collector relinquishes is “free” to be paid as interest. An incidental political effect of rising debt/income ratios is to transfer the economy’s planning and management to the financial sector in a client relationship, while endowing the FIRE sector with economic power to lobby for tax favoritism for *rentier* activities;

(5) by far the main cause of today’s economic polarization is debt-financed capital gains. We know that because the magnitude of these gains far exceeds GDP itself. The debt creation that fuels this process is shrinking the non-financial economy, not helping it grow.

(6) Our analysis also has an implication for monetary theory. The traditional $MV=PT$ formula implies that more money will raise consumer and commodity prices. But most money takes the form of endogenous bank credit, and is lent out as mortgage loans to finance the purchase of real estate, and to Wall Street and other financial sectors to buy stocks, bonds or other assets. The effect is to bid up the price of these assets, including housing. Having to buy a new home at rising prices leaves less disposable income available to spend on goods and services – which is implicitly deflationary. And to the extent that the inflation of stock and bond prices reduces current income or pension funds, their arrears rise. That may trigger a legal obligation for employers to set aside more of their income in their pension plans, leaving less for new capital investment and employment.

To provide a statistical picture of how wealth is achieved and to distinguish between earned income (wages and profits) and unearned economic rent (transfer payments), national statistical authorities would need to provide the following data:

First, Asset-price gains would have to be calculated for real estate, stocks and bonds. At present, this can only be estimated indirectly, by taking the total value of asset holdings and subtracting new construction, bond and stock issues. Many countries do not collect such statistics because they do not even tax capital gains – a practice that we think is an egregious gap in tax policy. Even when such statistics are collected, distinguishing domestic from foreign and “faux-foreign” asset holders operating out of offshore banking centers is difficult because of the “veil of tiers” used by tax accountants for major individual and corporate investors. In view of these statistical problems, our recommendations must remain primarily conceptual for the present time.

Second, with regard to what is product and what is not – and hence, what revenue is part of the production-and-consumption process in contrast to transfer payments with no quid pro quo, and hence a subtrahend – the NIPA should treat the FIRE sector and monopolies as a distinct *rentier* sector.

Third, within this segregation of *rentier* income, we need the actual Internal Revenue Service figure for real estate depreciation as filed by absentee landlords. Contrasting this large magnitude with the relatively miniscule statistic reported in the NIPA for “actual” depreciation will largely increase our estimate of “fictitious” earnings. The reality is that most absentee owned property does not deteriorate, but actually rises in value – as the Federal Reserve’s Table Z recognizes this by increasing the statistic for the value of buildings (based ultimately on Census Dept. figures) by the construction-price index. Many states require landlords by law to maintain their properties to prevent their deterioration, as part of their obligation to their renters. The tax loophole of “over-depreciation” thus is one of the most egregious distortions in national income statistics.

Lobbying power by the FIRE sector is the major hurdle blocking a more realistic or “classical” profile of the economy’s output and wealth. Vested interests seek to protect themselves, and the wealth of *rentiers* has increased sharply since about 1980. After all, it took the entire “long 19th century” for classical economists from the Physiocrats and Adam Smith through Mill, Marshall and others to try to calculate and tax unearned income in the form of land rent, monopoly rent and financial rents. That century-long effort ultimately failed, and classical value, price and rent theory was replaced by a “value-free” theory denying that any income or wealth was unearned.

Our proposals for a more realistic economic accounting format thus may appear politically to be a Quixotic attempt to revive a lost world. But in our opinion, our proposed statistical format provides a more realistic picture of how the world actually works and why economies have been polarizing so sharply since 1980.

(REFERENCES TO BE INCLUDED)