BOOK REVIEW

Thomas Piketty

CAPITAL in the 21st Century

(Translated to English

by Arthur Goldhammer)

England, UK: Belknap Press of
Howard University Press, 2014

Sri Lanka Journal of
Economic Research
Volume 5(1) November 2017
SLJER.05.01.B:
pp.105-113
Sri Lanka Forum of
University Economists

Umesh Moramudali

Research Analyst, Ministry of Finance, Colombo, Sri Lanka

Telephone: +94-775 93 92 51; Email: moramudaliumes@ gmail.com

INTRODUCTION

Thomas Piketty's *Capital in 21st Century* was published in 2014 and was a New York Times Bestseller. Piketty is identified as a unique economist who distances himself from the usual economic research methodologies and literature. In an era when almost every economist fails to conduct research without econometrics modeling to accompany his or her efforts, Piketty makes a conscious choice to not include any econometrics model to his *magnum opus*: tending to be more in line with the tradition of political economy and the treatment of economics as a social science. The book, which was originally written in French, was later translated to English by Arthur Goldhammer and consists of fascinating attempts to relate economics to literature, particularly the works of Jane Austen and Honoré Balzac, as well as to Orhan Pamuk and Naguib Nahfouz: which is indeed seen as a unique style of writing in economics.

The book, which accounts for more than 700 words, has four parts titled 'income and capital', 'dynamics of the capital/labour ratio', 'the structure of inequality' and 'regulating capital in the twenty first century'. In these four parts, Piketty discusses topics such as the capital-labor split in the long run, the capital/income ratio, public wealth

(including public wealth in a historical perspective), capital's comeback in rich countries since the 1970s, and the capital-labor split in the twenty-first century

Capital accumulation vs economic growth

Piketty's findings challenge the arguments of classical economists about productivity gains leading to economic growth and subsequently distributing wealth amongst the people in a fair manner. Findings also revealed that, during the last four decades, income distribution had worsened, thereby intensifying inequality. Accordingly, 60% of the US national income from 1977 to 2007 was acquired by the top 1% of earners, and this was identified as a significant number in terms of income inequality.

Piketty's argument is simple: he claims that the rate of capital accumulation has been higher than the economic growth rate and that, as a result, increases in income had benefited those who own capital thereby increasing inequality. He predicts that this trend is likely to continue; as a result of which wealth inequality will rise further. This scenario is referred to as the 'central contradiction of capitalism', and, as Piketty summarises, in Marxist terms: 'the entrepreneur inevitably tends to become a rentier, more and more dominant over those who own nothing but their labour. Once constituted, capital reproduces itself faster than output increases. The past devours the future.'

Against this backdrop, Piketty argues that wealth begets more wealth, allowing those who own capital to become richer, while hindering opportunities for others to become wealthier.

He also observes a strong comeback of private capital in the rich countries since 1970, which he term as 'the emergence of a new patrimonial capitalism'. According to Piketty, the growth of a true "patrimonial (or propertied) middle class" was the principal structural transformation of the distribution of wealth in the developed countries in the twentieth century. (326)

Capital/Income ratio

The Economist magazine hails Professor Piketty as 'the modern Marx' due to similarities of thought between the two. Piketty worries about the trend of rate of return for the wealth being higher than the economic growth rate and claims that the trend has changed only in the presence of strong government intervention. He argues that in the absence of such intervention, particularly in terms of progressive taxation, patrimonial capitalism results, allowing the economic elite to gain fortune through inherited wealth rather than through innovation or entrepreneurship; thereby impeding chances for workers to gain fortune.

Piketty uses the capital-income ratio¹ as an important indicator in explaining the dynamics of wealth inequality. He observes that in societies where the capital-income ratio is high, inequality too tends to be high. Accordingly, the capital-income ratio in Europe during the 1800s and 1900s was between six and seven. However, prior to the First World War and in the aftermath of the Second World War, this ratio was around two or three, making these societies more equal and allowing workers to become wealthier. The reason for this phenomenon is the high adoption of progressive taxation practices by governments in light of the war.

In the long run, the ratio between capital and income ratio is equal to that between savings and growth, and hence savings are directly related to capital accumulation. The higher the savings, higher the capital-income ratio will be. However, growth is inversely related to the capital-income ratio, and therefore, when growth is slow, the capital-income ratio would be high (and *vice versa*). The book observes that workers are better off in a situation where the capital-income ratio is less.

Piketty observes that wealth inequality will not be reduced in the modern era unless a significant shock impacts the economy. During the World Wars and soon after, inequality was less due to progressive taxation and the loss of property experienced by the wealthy.

Piketty's findings are in line with those of some renowned economists who criticise neoliberalism, which seems to be the economic ideology that dominates global economics. Nobel Prize-winner, Joseph Stiglitz, in his book *Great Divide*, notes that the upper one percent of Americans are taking in nearly a quarter of the nation's income every year, and that the top one percent control 40 percent of wealth: as opposed to the 12 percent of income received and 33 percent of the wealth owned by the top one percent 25 years ago.

According to Stiglitz, the standards of living of the top one percent income earners have improved considerably. While they have seen their incomes rise 18 percent over the past decade, those in the middle class have actually seen their incomes fall. All the growth experiences in recent decades – and more – has gone to those at the top. These numbers too support Piketty's argument that those who have inherited wealth had acquired more wealth, making the societies more unequal.

The book also claims that much of the wealth in 21st century is private wealth and that those who own it prefer to lend it to the government rather than to pay taxes. As a result

1. What is Income? "National income is defined as the sum of all income available to the residents of a given country in a given year, regardless of the legal classification of that income." [pg. 43]

What is Capital? "[C]apital is defined as the sum total of nonhuman assets that can be owned and exchanged on some market." [pg. 46]

the government ends up paying interest to those who lend and further expanding the wealth of those who own capital.

Demographics and inherited wealth

Piketty makes very interesting observations about changing life expectancy and its impact on the transfer of inherited wealth. He observes that although the increase of life span had delayed the transfer of inherited wealth to heirs, a significant portion of wealth is transferred through gifts. Piketty observes that the value of gifts given to heirs had increased significantly. According to data presented in the book, gifts during the 1870 to 1970 period amounted to around 20 to 30 percent of inherited wealth; a number which had risen 80 of inherited wealth between the years 2000 and 2010.

Public wealth and debt

Piketty observes that while private capital increased since the 1970s, public capital had not increased in relation to private capital. Furthermore, once massive public debts are taken into account, public wealth amounts to less than one percent of national income. Accordingly, in Britain, private capital amounted to five times the national income in 2010 (it was 300% in 1970) and in France private capital amounted to almost six times the national income in 2010 (in 1970, this figure was 300%), while public capital was only around 10% and has been stagnant since 1970's. In the United States private capital amounted to 400% of national income in 2010 (up from 320% in 1970) while public capital had decreased significantly from around 75% of national income recorded in 1970s to about 10% in 2010. By 2010, despite the 2008 financial crisis, 'capital was prospering as it had not done since (158)'.

The change in these dynamics appears to have resulted from neoliberal policies adopted since the 1970s. Deregulation of markets, tax cuts to the businesses, privatisation and other similar policies followed with the fancy expectation of trickle-down have caused a significant increase in the private wealth of those in the high-income bracket, thereby increasing wealth inequality.

However, Piketty fails to dig deep into the issue of public debt or to analyse its impact on inequality. Given that a major portion of public expenditure is allocated for debt servicing, for contracting public investment, and for welfare, it would be interesting to investigate to what extent those who gain wealth benefit from public debt.

A different type of capitalist class – super managers

Piketty observes that the dynamics of the wealthy class has changed from 1800s. Back then, those who had wealth did not work, but relied on income received from capital and

rent. In contrast, in the modern age the wealthy are likely to work and most of those who are in high income brackets are those who hold positions in corporate world: for instance, Piketty observes that the salaries of CEOs had soared during the last few decades.

It was observed that soaring of top executive pay began in the early 1980s with the rise of neoliberalism during the tenure of President Ronald Reagan. Tax rates on those who are in high income brackets were cut down from about 70 percent to 40 percent. This resulted in top executives receiving large salaries and an increasing wage gap. Literature also identifies that during the last several decades, as the living standards of most Americans have remained stagnant or gone backwards, top corporate pay has grown by outrageous proportions (Morrissey, 2013)

Piketty uses the term 'super managers' to identify those who receive massive salaries as corporate executives. He observes that this phenomenon is particularly prominent in the US and the UK, and that their incomes include stock options and bonuses. Piketty posits that these super managers earn high incomes without any outstanding performance which contributes to economic growth.

Reviewers attribute this scenario to the rapid expansion of financialisation, a term used by economist David Harvey to describe the expansion of the financial industry. The returns of the financial industry have risen drastically as observed by many economists. The documentary 'Inside Job' highlights that executives in the financial industry are amongst highest-paid in the corporate sector. As Talton (2016) observes:

According to reports, in 2015, the average chief executive of an S&P 500 company was paid 335 times more than the average non-supervisory worker. This stunning disparity has been the norm since the 1990s, but it wasn't always this way. In 1965, the average CEO made 20 times the pay of the average worker; it was around 34-to-1 in 1980. By 1998, it was nearly 322-to-1.

Piketty attributes the increase of remuneration for managers to falls in marginal taxation, which have increased the incentive to bargain for higher pay and been reinforced by changes in social norms. However, the alternative view presented by Wolf states that the marginal productivity of top managers has exploded, partly because the marginal product of a manager is not measurable and partly because overall economic performance has not improved since the 1960s (Wolf, 2014).

COMMENTS AND CRITICISM

Being a New York Times No. 1 Bestseller, Capital in the Twenty-first Century has received as much praise as it has criticism. Christel Lane, Emeritus Professor of Economic Sociology at the University of Cambridge, notes that Piketty presents two new

fundamental laws of capitalism. According to Lane, Piketty uncovers structural contradictions which are likely to grow to such a degree that they threaten to overwhelm societies and politics in the twenty-first century. This argument is based on the significant rise of the capital-income ratio due to the higher rate of return for capital than the rate of economic growth.

Lane identifies Piketty's second fundamental law of capitalism to be the inclusion of national savings in the equation; thereby showing that, in countries which save a lot and which have low demographic growth, capital inequality will become particularly pronounced.

As one would expect, Piketty does not receive positive responses from a majority of the corporate sector, particularly from those affiliated to finance. Writing in the *Wall Street Journal*, Daniel Shuchman, a fund manager, fumed at the book's 'medieval hostility to the notion that financial capital earns a return'.

Meanwhile, Clive Crook, a columnist at Bloomberg raises questions about the level of future inequality predicted by Piketty and questions whether it is as 'terrifying' as Piketty claims. Some critics raise concerns regarding one of the fundamental laws proposed by Piketty: ' $r > g$ '; meaning that the rate of return on capital is generally higher than the rate of economic growth; claiming that ' r ' is not well-defined. Furthermore, writing in *Foreign Affairs*, Tyler Cowen of George Mason University reckons Piketty identifies capital as a 'growing, homogeneous blob', and so fails to take account of the variation, across time and investments, in the returns to wealth (Economist, 2014).

Furthermore, another set of critics claim that Piketty ignores basic economic principles in developing his theory on capital accumulation. Those who criticise Piketty on this ground claim that return on capital should fall as it accumulates. Kevin Hassett, of the American Enterprise Institute, a free-market think-tank, opine that return on capital should fall fast enough as wealth builds and that the share of income that goes to owners of capital should not rise in the manner Piketty claims.

However, many attribute this disagreement to the way in which Piketty defines capital. Piketty's definition includes forms of wealth, such as land, that would not figure in economists' models of production. Piketty also argues that the return on capital can be propped up by technology, which could lead to new ways of substituting machines for people. The rate of return of these forms of wealth is indeed likely to grow as opposed to decline as critics suggest. Moreover, the definition adopted by Piketty regarding capital seems sensible than the traditional definition of capital as almost all forms of capital that Piketty includes in his definition contribute significantly to gaining returns.

Meanwhile, David Harvey who is identified as a post-Marxist and an economist who appears to think along the same lines as Piketty claims that Piketty fails to provide an adequate explanation regarding the laws of capitalism proposed by him. While commenting that Marx would obviously have attributed the existence of such a law to the imbalance of power between capital and labor, Harvey attributes the steady decline in labour's share of national income since the 1970s to the declining political and economic power of labour in light of capital mobilized technologies, unemployment, off-shoring and anti-labour politics (such as those of Margaret Thatcher and Ronald Reagan). Harvey also goes on to say that irrespective of definition, those who own capital always create artificial scarcity of capital and ensure that the rate of return for the capital is high, so that it always exceeds the rate of growth of income.

Piketty and Kuznets

Correlation between the expansion of economies and their inequality has been a long-standing debate. One important finding in relation to this debate was presented by Simon Kuznets in 1955 who concluded that inequality increases during the initial phase of development, but begins to decline after a certain point. Kuznets developed an inverted-U shaped curve taking per capita income as the x-axis and inequality as the y-axis. According to his findings, after a country achieves certain level of per capita income, the trend of increasing inequality reverses and starts to decline. This was the view held by many conventional economists as well as the World Bank and the International Monetary Fund.

However, detailed analysis of Piketty regarding income inequality challenges the ideas presented by Kuznets. Piketty argues that the Kuznets curve theory had, for the large part, been formulated for the wrong reasons and that its empirical underpinnings were extremely fragile. The sharp reduction in income inequality that we observe in almost all rich countries between 1914 and 1945 was due above all to the World Wars and the violent economic and political shocks they entailed, especially for people with large fortunes. It had little to do with the tranquil process of inter-sectoral mobility described by Kuznets.

Piketty's findings reveal that the top decile claimed as much as 45 to 50 percent of national income in the 1910s and 1920s before this figure dropped to between 30 and 35 percent by the end of the 1940s. Inequality then remained stable at this level from 1950 to 1970, followed by a rapid rise in inequality in the 1980s and returning to 45 to 50 percent of national income by 2000. This clearly disproves the arguments presented by Kuznets. Further, income inequality in the US, when plotted, bears greater resemblance to a U-shape than to an inverted-U shape as seen in the curve presented by Kuznet.

Relating Piketty to Sri Lanka

Piketty's observations regarding several countries can be tested in the Sri Lankan context as well. Although this review fails to identify the growth of public wealth and private wealth over the decades due to difficulties in finding data it is attempted to examine the change of income inequality during the last decade.

Since the end of the war in 2009, Sri Lanka has graduated from lower to middle income status, and reduced poverty from 15.2 percent in 2006/7 to 6.7 percent in 2012. However, data shows that income inequality remains very high.

Statistics show that income inequality hardly decreased in the 22 years from 1990 to 2012. According to the data, the share of the poorest quintile in national consumption declined from 8.9 percent in 1990-1991 to 7.1 percent in 2006-2007, and then increased marginally to 7.7 percent in 2009-2010.

The share of household income of the poorest decile has remained less than two percent, while the corresponding share of the richest decile has remained around 38 percent throughout the period from 1990/91 to 2012/13 (Nanayakkara, 2016).

Observations show that Sri Lanka failed to reduce income inequality through economic liberalisation as well. After the liberalisation of the Sri Lankan economy in the late 1970s following the neoliberal wave initiated by Ronald Regan, Sri Lanka's income inequality had not shifted. In 1978, the highest 10 percent of income earners received 39 percent of total income while the lowest 10 percent of income earners received 1.5% of the total income. After 35 years since liberalisation, these numbers have hardly changed. In 2012 income received by the top 10 percent income earners amounted to 38 percent, while income received from the lowest 10 percent of income earners was around 2 percent. This reflects that only the wealthy had benefited from growth while the income received by the poor remained stagnant despite country being upgraded to middle-income status.

Furthermore, more than 80 percent of tax revenue being generated through indirect taxes also reflects that the wealthy are not taxed sufficiently. Against this backdrop, Piketty's recommendation that a tax be levied on wealth is identified as an important proposal to implement in Sri Lanka. In fact, through latest amendments to the Inland Revenue Act it was proposed to impose a 10 percent tax on capital gains which this reviewer identifies as a positive move towards reducing inequality by introducing a direct tax on various forms of wealth.

CONCLUSION

Capital in the Twenty-first Century presents several important findings including two fundamental laws of capitalism proposed by the author Thomas Piketty. According to Piketty, wealth grows faster than economic output: as he captures in the expression $r > g$

(where r is the rate of returns on wealth and g is the economic growth rate). Moreover, he concludes that faster economic growth reduces the value of wealth in an economy and vice versa. As per his observations, the world has experienced slow growth last few decades, thus increasing the value of wealth, which subsequently benefited those who own capital. Thereby, Piketty recommends that governments adopt a global tax on wealth in order to prevent soaring inequality.

The book is very well-written, explaining its arguments in laymen's language unlike many economics books written in this era. The ideas presented in the book are well-supported by data. Although there are criticisms against the definition of capital adopted by him, it appears to be the most comprehensive definition given to the capital as it captures various types of wealth.

However, Piketty's recommendation seems to lack pragmatism and feasibility for implementation. Moreover, the book lacks specificity on the ways by which a global tax on wealth maybe introduced, wealth could be quantified, or the political consequences of introducing such a tax could be ascertained. Further, this reviewer identifies a vacuum in detailed research regarding public debt and its impact on wealth: a research problem worth looking into. It is also identified that there is a dire need to conduct similar research in Sri Lanka which appears to be impeded by the dearth of data.

REFERENCES

Columnist, J. (2016). *Pay disparity is stunning between CEOs, workers*. [online] The Seattle Times. Available at: <https://www.seattletimes.com/business/economy/pay-disparity-is-stunning-between-ceos-workers/> [Accessed 2 Oct. 2017].

Economist.com. (2017). *Cite a Website - Cite This For Me*. [online] Available at: <https://www.economist.com/news/finance-and-economics/21601567-wonky-book-inequality-becomes-blockbuster-bigger-marx> [Accessed 2 Oct. 2017].

Lane, C. (2014). *Book Review: Capital in the Twenty-First Century by Thomas Piketty | British Politics and Policy at LSE*. [online] Blogs.lse.ac.uk. Available at: <http://blogs.lse.ac.uk/politicsandpolicy/book-review-capital-in-the-twenty-first-century-by-thomas-piketty/> [Accessed 2 Oct. 2017].

Piketty, T. and Goldhammer, A. (n.d.). *Capital in the twenty-first century*.

Shuchman, D. (2015). *Thomas Piketty Revives Marx for the 21st Century*. [online] WSJ. Available at: <https://www.wsj.com/articles/book-review-capital-in-the-twenty-first-century-by-thomas-piketty-1398118166> [Accessed 2 Oct. 2017].