Inequality on the Envelope: A Review of Thomas Piketty's

Capitalism in the Twenty-First Century

Thomas Piketty has written a wonderful book expanding and enlarging our understanding of a generally recognized and major long term social phenomenon - increasing income and wealth inequality around the world. He and his associates deserve our thanks for having provided a rich and transparent source of data and analysis that should provoke serious consideration of this topic for decades to come. The book is long and to his credit Mr. Piketty has made enormously detailed appendices and datasets available free online for those who wish to study the topic more carefully.

The general theme of the book is that free-wheeling capitalism is a system that cannot guarantee fair and equitable distributions of income and wealth, even when competition, self-interest, and *laissez-faire* are promoted. He takes it as self-evident that a worsening of income inequality is anti-democratic and that the solution is for governments to impose a progressive annual wealth tax.

Beginning with the theories of Malthus, Ricardo, and Marx, Mr. Piketty shows that the 19th century thinkers were correct in placing distribution of income as the central issue in economics. He then shows that decreasing inequality, occurring in the early 20th century and evidenced from the newly developed method of national income accounting and income tax returns in the US, led Simon Kuznets to speculate that capitalism would produce first rising inequality followed by a gently falling level of inequality - the so-called Kuznet's curve. However, beginning in 1975, income inequality again began to worsen and this led Mr. Piketty to seek more recent data from the US, UK, France, Germany, and Japan. His major theoretical contribution is that capital's share in the functional distribution of income will rise if the real return on capital (r) exceeds the growth rate of real income (g). His data is a welcome and needed addition to the ongoing debate.

In reading Piketty's book one finds it easy to apply the ideas of the socialist Polish economist Michal Kalecki to his analysis to obtain a neat and elegant presentation. For example, we might begin with national income (excluding government and external trade)[1]

$$
\begin{aligned}
\text{National Income} &= Y \\
&= \text{Wages} + \text{Profits} \\
&= C + I \\
&= \{\text{Consumption of Labor} + \text{Consumption of} \\
&\qquad\qquad \text{Capitalists}\} + \text{Investment}
\end{aligned}
$$

Now, if labor saves nothing, we have Kalecki's famous equation

[1] In this derivation I will treat all variables as being real rather than nominal. Naturally, the transition from nominal variables to real is quite treacherous and I do not seek to downplay the fact that the analysis is extremely simplified and abstract. It goes equally well that the above derivation is my own and not Piketty's, but it captures his argument well and underscores the broad and sweeping ideas that must be applied to obtain his fundamental relation between r and g.

$$\text{Profits} = \text{Consumption of Capitalists} + \text{Investment}$$

Next, suppose the consumption of capitalists out of profits is a very small fraction, say θ, which taken with the above equation implies

$$(1-\theta)\text{Profits} = \text{Investment}$$

But, Profits = rK and Investment is ΔK (assuming no depreciation), meaning that

$$(1-\theta)r = \Delta K/K$$

By definition, capital's share of Y, can be written as

$$S_K = \text{Profits}/Y = rK/Y$$

and therefore

$$\Delta S_K/S_K = \Delta r/r + \Delta K/K - \Delta Y/Y$$

If r = constant, then $\Delta r/r = 0$ and

$$\Delta S_K/S_K = (1-\theta)r - \Delta Y/Y \approx r - g$$

where $g \equiv \Delta Y/Y$. Clearly, given the analysis above, capital's share of the national income (S_K) will rise so long as r is sufficiently higher than g.

Despite the breath and elegance of his thought, in the end there is much that is wrong with Mr. Piketty's analysis, despite the fact that his book has been reviewed very favorably by at least two Nobel Prize winners (i.e. Paul Krugman and Robert Solow). For one thing, it seems clear to me that we all collectively own enormous amounts of wealth (stock, houses, land, public capital, human capital, bank deposits, pensions, consumer durables, etc.), meaning that sometimes we are capitalists and sometimes we are laborers. Thus, a rise in capital's share simply means we are being paid income into our right pocket rather than our left pocket. True, there remains the small, but much feared, extravagantly paid leisure class (coupon-clippers); but this group seems far too politically diverse to pose any threat to democracy. Also, Mr. Piketty somehow feels that taxing the rich is a way of equalizing wealth. But, government is often the instrument people use to acquire wealth and then channel such wealth to their friends. Isn't that the very definition of power and privilege? Simply moving funds from one set of rich people to another set of rich people seems a fruitless exercise, if the goal is to produce a more equitable distribution of income and wealth. Finally, in many cases, this much feared leisured class ends up funding universities like Harvard, Yale, Stanford, and Chicago with enormous bequests and endowments, not to mention their donations to hospitals, churches, NGOs, and charities. Are we to believe that government could do a better job of allocating resources than bequests and endowments - I think not. The real guard against worsening income and wealth distribution, by Mr. Piketty's own admission, is to have strong and steady growth of labor productivity. It reduced inequality from 1913 - 1970 and it can do so again. Perhaps we should instead focus on how to stimulate labor productivity; now that's a topic worth an additional 500 pages of hard work.