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# Piketty: inequality, poverty and managerial capitalism

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### Introduction

Thomas Piketty has provided an impressive amount of data which shows that inequality, under capitalism, goes hand in hand with economic growth. In principle, one could think that Piketty illustrates with abundant data Marx's assertion that capital has the tendency for concentration and centralization in the hands of the richest capitalists. However, the French author anxiously makes it clear from the very beginning that he is not following what he calls the "Marxist principle of infinite accumulation".

His contribution is threefold. First, he argues that to the extent that the rate of capital accumulation (*r*) is higher than the rate of growth of the economy (*g*), inequality expands; the reward to capital grows faster than the payments to labour. Second, he includes a methodological innovation which consists in resorting to tax records, a source of data usually forgotten by economists dealing with distribution of income calculations. Instead, Piketty has found ways to merge tax data with other sources to produce information that complements survey evidence. Finally, he concludes with a recommendation for a progressive global tax on capital although Piketty understands that this is now utopian.

To check the accuracy of the huge amount of data included in Piketty's book is something well beyond what a reviewer can do. So, I will assume that its empirical part is correct.

As we shall see, there are some contradictions in his line of reasoning and also my feelings after reading the book are contradictory. The first one – as it happened with many colleagues – is surprise at the fact that the book has become a bestseller, something quite unusual for an economics book.

So, the first task is to try to explain the reasons for such an unusual success. Some difficulties found in Piketty's book will also be pointed out. The relationship between inequality and poverty is analysed and some implications in terms of economic policy are made explicit. A brief digression is made on the relationship of Piketty's findings with the Kaldorian model of economic growth. Finally, attention is drawn to Piketty's findings on income distribution as different from wealth distribution.

### Reasons for the success of Piketty's book

What are the reasons for Piketty's phenomenal success, centred in the United States? First of all, the book's timing. Rising income and wealth inequality have suddenly become top issues in the American agenda after the financial crisis of 2008 and its consequence, the Great Recession.

However, as Tom Palley points out, they are phenomena that have been documented for years, although less comprehensively. For example, James Galbraith substantially confirmed that picture in his 1998 book *Created Unequal: The Crisis in American Pay*. Rising US income and wealth inequality was the subject of the book Edward Wolff co-authored in 2002 under the title *Top Heavy: The Increasing Inequality of Wealth in America and What Can Be Done About It*, and he insisted on this theme in his 2008 book *Poverty and Income Distribution*.

Why did the young French author succeed now where others failed before? In a nutshell, he was at the right time in the right place with the right ideas.

This shows once again that "economic ideas go through a selection process which is strongly context-dependent" (Beker, 2005, p. 18).

A second reason for Piketty's extraordinary success has been his scarce use of economic theory. He does not involve himself in theoretical discussions. His results rest on what he calls "the central contradiction of capitalism", i.e. the rate of return on capital systematically exceeds the overall rate of growth of income: $r > g$.

However, strictly speaking, Piketty's conclusions rest on $s.r > g$, not $r > g$, where $s$ is the proportion of $r$ capitalists reinvest. In fact, if $r > g$ but $s.r < g$, capital will grow slower than average income, contrary to Piketty's main thesis. The author seems to assume that if $r > g$ then $s.r > g$ automatically follows.

Third, Piketty has shown that growing inequality is a result absolutely compatible with neoclassical economic theory, which does not preclude at all the possibility that $r$ may outstrip $g$.[1] So, his findings have become absolutely palatable for a broad fraction of mainstream economists.

However, his allegation that in the long run $r$ is relatively stable contradicts one of the fundamental laws of neoclassical economic theory: diminishing returns to an abundant factor of production.[2] It also contradicts the Marxian law of the decreasing rate of profit. Piketty mentions this law stating that "Marxist analysis emphasises the falling rate of profit—a historical prediction that has turned out to be quite wrong". It also contradicts Keynes's prediction on the euthanasia of the rentier.

A fourth reason, pointed out by John Weeks, is that Piketty avoids any discussion of macroeconomic policy. His book is narrowly focused on inequality, trying to show that its long-run increase is just a law of capitalist development. So, he avoids any political debate.

Last but not least, his writing is very easy to read and understand. He writes in the literary tradition of Adam Smith, Marx, or Keynes and derides economists who "rely on an immoderate use of mathematical models, which are frequently no more than an excuse for occupying the terrain and masking the vacuity of the content". Instead, he builds a clear and convincing story on the basis of a formidable database on the distribution of income and wealth from more than twenty countries. His success seems to confirm McCloskey's *dictum*

[1] Ray (2014) argues that $r > g$ is a consequence of *any* model of growth, provided that we insist on "dynamic efficiency". He adds that dynamic efficiency simply states that an economy does not grow so fast as to spend, so as to negate, the initial (economic) purpose of growth, which is to consume.

[2] *Piketty does not ignore this issue but he argues that the* interesting question is not whether the marginal productivity of capital decreases when the stock of capital increases – which he accepts as obvious – but rather how fast it decreases. He goes on, arguing that the decline in $r$ is compensated by the rise in the capital/income ratio. "The most likely outcome is thus that the decrease in the rate of return will be smaller than the increase in the capital/income ratio, so that capital's share will increase". However, Piketty keeps arguing that $r$ is relatively stable over the long run at around 4–5 per cent.

that science – and particularly economic science – is persuasion and that rhetoric plays a key role in that.

Piketty defines as capital any source of non-wage income. So, he includes housing, cash, bonds, shares, intellectual property, and even the property of slaves.

In this respect, Bonnet et al. (2014) argue that once housing prices are removed from the Piketty compilation of capital, the phenomenon of rising share of capital income goes away. They remark that over the longer run the "productive" capital/income ratio has not increased at all; "productive" capital only has risen weakly relative to income over the last few decades. If so, it would mean that Piketty's conclusions are strongly determined by the secular increase in the price of a quasi-fixed factor of production as urban land is. In such a case Piketty would be bringing back to life Ricardo's land-scarcity analysis, with the emphasis now on urban instead of rural land. But, as Rowthorn (2014) points out, if the increase in the capital-output ratio that Piketty detects is mainly due to an increase, in recent decades, in the market value of certain real assets (especially housing), it may be that the truth is that there has been no over-accumulation of capital, as Piketty states, but, on the contrary, under-investment. Piketty himself remarks that real-state capital roughly represents 50% of capital in developed countries.

In spite of the weight Piketty gives in his argument to the $r > g$ relationship, he admits that "the reduction of inequality that took place in most developed countries between 1910 and 1950 was above all a consequence of war and of policies adopted to cope with the shocks of war. Similarly, the resurgence of inequality after 1980 is due largely to the political shifts of the past several decades, especially in regard to taxation and finance". But this implies that the main determinant of the ups and downs of inequality has been the changing correlation of forces – mainly between capital and labour – and not the $r > g$ relationship. This changing balance of forces has resulted in different policies over time from the welfare state of the post-war period to neoliberal deregulation. For example, until the appearance of Piketty's book, the resurgence of inequality after 1980 has been considered the direct effect of Reagan-Thatcher economic policies that, among other things, eroded union power. He admits that the inequality $r > g$ is a contingent historical proposition, which is true in some periods and political contexts and not in others. Therefore, is inequality just the result of an intrinsic trend in capitalist development or is it the consequence of policies like the ones which consisted of deregulation, weakening of the labour unions and the like? Piketty himself seems to choose a middle-of-the road explanation. He recognises that there are "powerful mechanisms pushing alternately toward convergence and divergence" as far as wealth distribution is concerned. However, he predicts that "certain worrisome forces of divergence" will prevail in the future but his forecast is based precisely on the behaviour of the United States and Europe after 1980. He maintains that "the return of high capital/income ratios over the past few decades can be explained in large part by the return to a regime of relatively slow growth". This made the rate of return on capital remain significantly above the growth rate. But the low rate of growth and the high rate of return on capital were not just the result of Reaganite and Thatcherite policies?

Nevertheless, after taking into account the different factors that he considers relevant he concludes: "the process by which wealth is accumulated and distributed contains powerful forces pushing toward divergence, or at any rate toward an extremely high level of inequality. Forces of convergence also exist, and in certain countries at certain times, these may prevail, but the forces of divergence can at any point regain the upper hand, as seems to be happening now, at the beginning of the twenty-first century. The likely decrease in the rate of growth of both the population and the economy in coming decades makes this trend all the more worrisome" because this will make sure the prevalence of $r > g$. He calls the $r > g$ relationship the "fundamental force for divergence". Once again, let us remember that he should have said $s.r > g$ not $r > g$.

Piketty's book is more descriptive than prescriptive. Its main recommendation – he himself admits – is utopian. What then is its added value?

First of all, it brings distributional issues to the fore of economic debate. According to David Ricardo, this is the "principal problem in Political Economy"[3] but it has been considered as an absolutely peripheral topic by contemporary mainstream economics. In Atkinson's words, "it has been very much out in the cold" for a long time.

Second, it follows the best traditions in economic literature. Piketty shows he is an economist with his feet on the ground who knows what value parameters may take in reality; he does not speculate with theoretical models where parameters may vary from 0 to ∞.

Third, it vindicates the need of collaboration between economics and the other social sciences: economics – he remarks – is just a subdiscipline of the social sciences, alongside history, sociology, anthropology, and political science. It also postulates a way of addressing research: to start with fundamental questions and try to answer them using the methods of economists, historians, sociologists, and political scientists, crossing disciplinary boundaries. This implies abandoning the traditional mainstream approach to economics as a "separate" science.[4] It also means to start research by choosing fundamental questions – as inequality – and not "by the possibilities of mathematically modelling the answers" (Beker, 2010, p. 19), which has been the fashion among mainstream economists.

### Inequality and poverty

Let me now ask an awkward question. Should reduction of inequality or reduction of poverty be our main concern? Surely the majority of readers will rush to answer that both goals should be pursued simultaneously. However, the relationship between inequality and poverty seems to be a complex one, particularly in poor countries. The recent international experience shows that far from being complementary objectives they may be rather opposite, which poses a real dilemma for economic policy. China experienced in the last years a strong reduction in poverty simultaneously with a significant increase in inequality. There may also be widespread poverty in a society with low levels of inequality. A decrease in inequality can also be accompanied by an increase in poverty.

Poverty has not been a great concern for mainstream economic policy. Only in 1969 Economics of Poverty was identified by JEL as a distinct field of research.

Klasen[5], from a policy perspective, defines pro-poor growth as growth that maximises the income gains of the poor. This means that the income growth rate of the poor must exceed

[3] Ricardo, D. (1817). Preface.
[4] See Hausman (1992) on the concept of "separate" science.
[5] Klasen, S. (2007). Ch. 13, p. 196.

the growth rate of the non-poor. In such a case, reduction of poverty goes hand in hand with reduction in inequality.

Basu (2005) argues that economic policy should take as welfare criteria a normative simple rule: maximising the per capita income of the poorest 20 per cent of the population. He calls this the "quintile income" of a country.

Of course, equality is a desirable goal – this is not under discussion – but the issue is how pro-poor growth can be obtained together with less inequality. Experience shows that less poverty not necessarily means less inequality and vice versa.

Piketty practically does not address the issue of less developed economies. His analysis focuses on the experience of Western developed countries and only includes a very brief reference to emerging economies. He believes that the historical trajectory of developed countries can tell a great deal about the future dynamics of global wealth, including emergent economies.

The truth is that for emerging economies, where basic needs are often not satisfied for a huge part of the population, poverty is on the top of the agenda. Fighting poverty should be the first priority for economic policy in these countries. It would be of great help for them to have a volume as Piketty's one but devoted to poverty, its relationship with inequality, its causes, and the ways to minimise it.

On the contrary, in developed countries inequality has become today the main concern. Why? Once basic needs are satisfied, people evaluate their economic well-being relative to others, not in absolute terms.

Orthodox economists reject this point of view. For example, Martin Feldstein (1999) argues that changes that increase the incomes of high-income individuals without decreasing the incomes of others clearly satisfy the Pareto principle and should be welcomed. I argued elsewhere (Beker, 2005) that a policy change that improves the situation of the upper one per cent of the population without changing the situation of the rest is undoubtedly a Paretian improvement but this does not mean it necessarily is a desirable outcome. I objected that this more efficient alternative – as it is called by mainstream economists – will be rejected in many societies in the name of *equity*. The Pareto improvement concept implicitly assumes that absolute and not relative situations are relevant. In our example, although the poor are not worse off in absolute terms they are in relative ones; this may make them feel poorer as if they had lost part of their income. To learn that reckless bank executives take home million-dollar bonuses in the middle of the Great Recession is undoubtedly scandalous for jobless and homeless people. It is society and not economists who should decide what weight should be given to efficiency and what weight to equity: it is typically a value judgment.

**From Kaldor to Piketty**

During the fifties, Nicholas Kaldor (1955, 1957) developed a model of economic growth and income distribution in order to explain the constancy of the capital-output ratio, the rates of profit on capital and the distribution of income. At that time, Kaldor maintained that these three ratios were constant over time, according to the data for the United Kingdom and United States economies.

In his model, the capital-labour ratio was driven to a steady-state equilibrium value by the different savings rates of capitalists and workers: if K/L rose above its equilibrium value, the wage-to-profits ratio would also rise. With workers' savings assumed to be lower than those of capitalists, this led to a decline in the rate of capital accumulation, driving K/L back down towards equilibrium.

Concerning the distribution of income, Piketty finds that the capital-labour split varied widely over the course of the twentieth century. He advises to focus on the analysis of the evolution of the capital/income ratio as a way of measuring wealth accumulation over time.

According to Piketty, the capital/income ratio has followed over the course of the century just past a "U-shaped curve". In fact, in Britain and France this ratio fell between 1914 and 1945 but then sharply increased in the period 1945–2012. He finds that the general evolution of the capital share of income is described by the same U-shaped curve as the capital/output ratio. Finally, as far as the rate of return is concerned, he maintains that it is relatively stable at around 4–5 per cent (it never falls below 2–3 per cent, he remarks). Finally, he states that once $r-g$ surpasses a certain threshold, inequality of wealth will increase without limit. In this respect, Piketty, in spite of his disclaimers, resembles Marx in his prediction of an increasing concentration and centralization of capital.

As far as Kaldor is concerned, Piketty rejects his assumptions: neither the capital/output ratio nor the distribution of income is constant over time. Moreover, above a certain threshold there is no equilibrium distribution. Only the rate of return is relatively stable in the long run.

**Inequality and top wage earners**

Although his analysis is centred on capital accumulation, Piketty argues that the rapid increase observed in inequality in the United States, which started in the 1980s, largely reflects an unprecedented explosion of very elevated incomes from labour. He attributes this phenomenon to the fact that top managers by and large have the power to set their own remuneration, in some cases without limit. This phenomenon is seen mainly in the United States and to a lesser degree in Britain while the tendency is less marked in other wealthy countries although the trend is in the same direction. So, he finds a growing concentration of income from labour and not only from capital. Moreover, the peak of the income hierarchy is dominated by very high incomes from labour. He characterises the United States at the moment as a society with a record level of inequality of income from labour. In a previous article[6] he and his co-author had already found that the composition of income in the top 0.01% in the United States is increasingly salaries, and a corresponding lower proportion is returns to capital. In this case, the control of capital seems to be more important than capital ownership from the income distribution point of view. At this point Piketty's conclusion

[6] Piketty, T. and Saez, E. (2006).

resembles John K. Galbraith's thesis of the rising power of the technostructure. "We have gone from a society of rentiers to a society of managers", Piketty remarks with reference to France. United States inequality has much to do with the advent of "supermanagers" who obtain extremely high, historically unprecedented compensation packages for their labour, he concludes.

So it seems that in spite of the growing concentration of capital property, the main beneficiaries of this process in terms of income have been the managers who administer it. The inequality $s.r > g$ may explain wealth evolution but income distribution needs another type of explanation.

If Piketty's claim is correct, it would be a formidable empirical argument in favour of managerial theories of the firm which argue that managers maximise their own utility while satisfying shareholders with a minimum level of profit.

However, there is something puzzling in Piketty's book: if, according to him, today's income inequality is mainly the result of labour income inequality, why does he devote 90 per cent of the volume to the study of wealth distribution and only 10 per cent to income distribution? I first thought it might be because he found greater availability of data concerning wealth distribution. However, in his answer to the *Financial Times*' critique, he admits that available data sources on wealth inequality are much less systematic than what we have for income inequality. So, the question remains open.

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