Notes for discussion of Thomas Picketty's *Capital in the Twenty-First Century*

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A public conversation on the Piketty phenomenon

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1

1

PICKETTY'S CONTRIBUTION:

Picketty opens his celebrated book by reminding us of the first article of the Rights of Man articulated as Revolution broke over France in 1789: "Social distinctions can be based only on common utility". That's not a bad premise for our democracy. A degree of inequality is justified to the extent that it serves a public purpose—like promoting general prosperity.

Picketty summarises and presents in an engaging way immense information on the distribution of income and wealth at various times since the eighteenth century, focusing on France, the United Kingdom and the United States. He touches upon other countries, mostly developed and mainly in Europe. He describes a simple economic model within which we can understand part of the change in the distribution of incomes over time—the part that derives from changes in the distribution between labour and capital. He discusses eclectically a range of other influences on the distribution of income and wealth. He applies insights from the model and the eclectic discussion to suggest that in the absence of political upheaval or new policies, inequality will widen to and perhaps beyond levels known in Europe in the Belle Epoch preceding the First World War. He comments that this is likely to be inconsistent with the ethos, good health and perhaps survival of democratic institutions and societies. Finally, he focusses on policy reform that could avoid the excesses of growing inequality and preserve democracy. While wealth will seek to use its influence in the democratic process to block the implementation of reforms to secure a democratic future, Picketty optimistically thinks that ideas will turn out to be more powerful than vested interests.

Picketty's biggest contribution is his data on incomes and wealth over long periods of time. He catches our interest by observing how the novels of Austen in Britain and Balzac in France capture the dynamics of societies in which a young person may find the material foundations for a satisfactory life in theft or in marriage into a large inheritance, but not in the application of youthful intelligence and energy to study and professional achievement. His data establish that inequality in the distribution of wealth and income in France, the United Kingdom and the United States tended to grow wider in the early stages of modern economic growth (in France, after the new taxation obligations and property rights established during the Revolution); shrink decisively from the outbreak of War a century ago until the 1970s; and grow wider again over recent decades. Income and wealth inequality was once much less in the United States than the old developed countries, but is now wider in the United States than in old Europe—as wide in the United States now as in Europe in the Belle Epoch.

The economic model that Picketty uses to explain growing inequality focusses on the distribution of income between capital and labour, which over time influences inequality in the ownership of capital. He notes that when the return on capital exceeds the growth rate of the economy, income from inherited capital tends to increase over time relative to income from labour (the latter broadly defined to include executive remuneration). He expects the rate of return on capital to remain more or less steady over future time as it has done in the past, and the rate of economic growth to fall over time with the slowing of growth in both population and productivity. It follows that he expects the share of capital in national income to rise over time, probably at a faster rate than in the recent past, leading to vastly increased inequality.

The eclectic discussion of inequality notes four big reasons why disparities in incomes and wealth may grow more rapidly than suggested by the basic model. First, alongside the rising share of capital in national income, there is a tendency for large fortunes to earn much higher returns than small accumulations of capital. Second, taxation rates on high incomes and on capital and especially on large concentrations of capital are being reduced by governments as a result of the influence of wealth in the policy-making process. Third, large but not modest fortunes can avoid and evade taxation through use of international tax havens and other opportunities provided by deepening integration of the global economy. And fourth, alongside the rising share of capital in national income, dispersion in labour incomes is growing considerably as remuneration for high level executives has expanded explosively since the 1980s, especially in the United States and other English-speaking countries, encouraged by lower taxation rates and weak representation of the public interest in remuneration decisions.

The book makes strong points about the relationship between the distribution of income and wealth on the one hand, and democratic policy-making and political stability on the other, but does not treat these relationships analytically. Picketty notes that policy—progressive income and capital taxes and expenditure policies—was important in the lessening of inequality in the mid-twentieth century; that wealth is highly influential in the policy process, and has become more so as disparities have increased; and that inequality of the dimension that is likely to emerge over the twenty first century is inconsistent with the ethos that underpins democracy and is likely to generate great tension and probably political instability.

Picketty's preferred policy response to preserve democracy and a market economy is for all countries to introduce a progressive annual global wealth tax. He acknowledges that for the time being international agreement on introduction of a progressive wealth tax is "utopian". Pending global agreement, good results could be achieved for the distribution of income within Europe from two achievable steps: international sharing of information on capital flows and other financial transactions; and the introduction of a progressive European annual wealth tax.

ASSESSING THE ARGUMENTS

It is worthwhile examining the model of distribution between capital and labour that provides the explicit analytic framework of the book, even though it turns out to be no more or perhaps less important than the eclectic contributions.

Picketty's conclusions about the future depend on his view that the rate of return on capital will not fall much from past levels. While Picketty notes that it is possible in principle that the rate of return on capital could fall with continued capital accumulation, he makes a great deal of the historical tendency for the pre-tax rate of return on capital to hold up at 4-5% per annum in real terms, and repeatedly asserts that it will continue to do so, more or less, in future. He recalls that other economists, notably Marx in the nineteenth century and Phelps and other contributors to twentieth century growth theory expected the return on investment to fall decisively over time. As a French economist, Picketty does not refer to the views on this particular matter of what I would consider to be a higher authority, John Maynard Keynes, in his 1930 essay, “The Economics of Our Grandchildren”, and in the concluding chapter of the General Theory in 1936. Keynes notes the propensity for owners of capital to accumulate without limit, with the consequence that the rate of return to capital would fall to near zero over the subsequent century. Far from leading to Picketty’s plutocracy, the abundance of capital would be associated with the solution to the economic problem around which human society had been organized since the beginning. Keynes thought his generation’s grandchildren a hundred years hence could look forward to the “euthanasia of the rentier”, seeing economists as being as uninteresting as dentists, and enjoying the higher delights of being human.

We might look at the return on investment since Marx, Keynes and Phelps and say that they were wrong. Picketty does.

Not so fast.

First, Picketty’s calculations on returns include capital gains. Since the turn of the century, asset values have been boosted continually by falling bond rates, Sovereign bond rates are now extraordinarily low by historical standards—yesterday evening in New York and London 2.4% for 10-year sovereign bonds, in Frankfurt 0.99% and in Tokyo 0.5%, all before deducting inflation and taxation. Long term interest rates cannot fall much lower, and so will soon cease to be a source of rising asset values.

Second, returns on investment in developed countries have been enhanced by the transmission of modern economic growth to much of the developing world over the past several decades. This can go on for a long time yet, but not forever.

The first of these cautions suggests that we may have already started moving towards the world of Keynes’ grandchildren, despite the opportunities for higher returns provided by accelerated economic growth in the developing world. At least the developed world may have started moving there--the steady falls in bond yields through the early twenty first century, the real rates near zero in the developed world since the Great Crash of 2008, and the low business investment at these low interest rates. Is it possible that only large capital flows into developing countries, and all the risks and institutional challenges that that entails, can sustain high demand and growth in the developed countries and avoid perpetually low returns on investment from some time not far from now?

We should not accept Picketty’s view of the future rate of return on investment, and the spectre of the return of Ancient Regime inequality that flows from it, without looking harder at Keynes’ alternative future.

I have another worry about the formal analysis. The main Picketty story of rising inequality sometimes purports to be of global relevance, but the data upon which it is based is a story of the old developed countries. If we look at the contemporary world, the rapid growth of incomes in China and some other parts of the developing world, the shift of growth in China (with three times as many people as the old three developed countries together) towards labour incomes as labour has become scarce over recent years, and the accumulation of much of the growing wealth of China and the developing world in State enterprises and sovereign wealth funds (with all the ambiguity about their de facto ownership) have caused global inequality to decline in the twenty first century so far. It is likely to continue to do so for as long as the developing world continues to "catch up" with the developed in average incomes and productivity—that is, so long as the maturation of modern economic development is not thwarted by a breakdown in domestic and international political order deriving from great disturbances (for which, regrettably, there are several possibilities, including unmitigated climate change).

None of this is to say that growing inequality in the old democracies does not matter so long as inequality is falling on a global basis. The prospects of democracy everywhere will be damaged if it is discredited in its early homes. Rather, we need to qualify the generality of propositions that are asserted powerfully by the author.

I also worry that both Picketty's theory and his eclecticism fail to discuss the contribution that is being made to global equality by falling fertility. A sharp deceleration of labour force growth in the world as a whole—and the possibility well before the end of the century of absolute decline—is raising the value of labour and hastening the emergence of an abundance of capital.

Capital will not quietly accept much lower returns. Its larger owners will seek to change policies to hold up the return on capital after tax in the face of powerful tendencies for it to fall. This is where Picketty's story of money distorting democratic processes in the late twentieth and early twenty first centuries assumes great practical relevance. Falling returns to capital encourage pressures for lower tax rates on capital and high incomes; for privatization of community and public assets whether or not there is economic justification in particular cases; for resisting regulation of business in the public interest; for turning competitive markets into monopolies; and for extension of changes in law and culture that have led to the explosion of executive remuneration in the early twenty first century.

RELEVANCE TO PUBLIC POLICY

Picketty focusses mainly on a single reform to avoid growing inequality and the corrosion of democracy: the progressive global annual wealth tax, or its more limited European version. Picketty recognizes that the best possible approach for the foreseeable future is concerted action in many countries to introduce broadly similar measures, together with the sharing of financial information, and strong action by the larger states to close down tax havens provided by small states.

I would not put my eggs only in that basket. The sharing of financial information amongst willing states would support a stronger effort to protect the public revenues from established taxes, and provide a basis for building international cooperation against the competitive corrosion of revenues from capital income as well as wealth. The focus on international capital flows and protection of the historical national tax base is an important focus of the G20 meeting in Brisbane in November, so cooperation in this area may not be utopian.

But the hatching of any of these eggs requires the reassertion of democratic sovereignty against the influence of money in the democratic developed countries. That is the starting point for effective policy change to reduce recent drift towards an excess of inequality that few citizens in the democratic states would consider acceptable. In my view, the most valuable practical step that we can take now in Australia is to get behind Premier Baird’s proposal for reform of campaign funding, and work towards the banning of all corporate including trade union political donations.

Clean up our plutocracy—remove the dominance of corporate money in contemporary democratic processes in the developed countries--and it will be possible to design and to implement financial reforms to reconcile a prosperous market economy with equity and democracy.