LECTURE 23: A SUMMARY OF CAPITAL IN THE 21ST CENTURY

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Introduction

- In the rich market economies of the world, the incomes of the wealthiest are rising, whilst the incomes of the majority are stagnating.

- The outcome is growing wealth and income inequality.

- None of this is in empirical dispute. What is in dispute is trying to explain *why* (i.e. the causal mechanism) and whether it is *justified* or not (normative legitimacy)?

Economic history

- Piketty wants to put the issue of inequality into a broader historical context. To do this, he traces the evolution of capital from the agrarian societies in the 18th century, through to the the 19th century, the inter war years, and into the second half of the 20th century.

- There are three conclusions from this comparative historical analysis on the political economy of distribution:

1. Inequalities of wealth and income are influenced by a whole host of institutions; political, economic, cultural and normative factors.
2. Markets when left to their own devices produce a high degree of inequality because the rate of return on capital always exceeds economic and income growth (R>G).
3. On the basis of this inequality (R>G), wealth tends to accumulate and concentrate at the very top of the income distribution.

- To tame market inequalities requires political intervention.

Institutions

- Democracies throughout the 20th century have pursued various public policy interventions to tame market inequalities: minimum wages, progressive taxation, capital controls, social programs, strengthening collective bargaining, trade unions, rent controls and corporate regulations.

- A core finding in political economy is that institutions, and their underlying political coalitions, shape market outcomes, and these vary significantly between countries and regions.
  - This is what we call comparative political economy.

- But since the 1980's those institutions that tended to create egalitarian outcomes have been gradually eroding with the implication that market inequalities are increasing.

Markets

- Global market liberalization has been constituted by the economics profession itself (and financial markets interests, in particular), who have tended to support those public policies that enable markets to get back to their competitive "natural tendencies".

- For Piketty, these “natural competitive market tendencies” logically lead to the inequality R>G, and undermine the meritocratic principles of democratic societies.

- When competitive markets are left to their own devices, capital-wealth accumulates and concentrates, with the implication that inheritance ends up mattering more than hard work.

- This is the core *normative* critique underpinning the book. It suggests that markets are not equalizing. When left to their own devices they leads to a corporate rentier society not a meritocratic society.

Wealth

- Lets unpack the concept of wealth, which is used interchangeably with the concept of capital in the book.
- The first question to ask is where does capital-wealth come from? There are two sources: inheritance and income (theft also matters).
- Income can be broken down into two sources: income from *labour* (wages, bonuses and salaries) and income arising from *owning capital* (rent, assets, interest, bonds, stocks, dividends).
- Wealth that accrues from either of these forms of income can be consumed, saved or invested. Most people barely earn enough income to cover their living expenses. They have no savings and no wealth.
- Capital only becomes true wealth when it is not immediately consumed i.e. when it accumulates in a savings account, re-invested in financial stocks and bonds, owned in real and/or commercial estate, machinery, buildings or land.
- Today, most capital-wealth is held in either housing or financial assets.

Capital/income ratio

- In any given society, total wealth equals public + private capital (minus debt). In all market democracies today, capital is almost entirely privately owned.
- For Piketty, the best way to analyze the importance of capital in a society (i.e. capitalism) is to measure the amount of wealth (stock) as it relates to income (flow). Dividing the total capital stock by national income gives us the capital/income ratio (β).
- Capital/income ratios are important because they provide us with a comparable quantitative measure to analyze capitalist development across time (history) and space (country).
- In most countries we find that, on average, national wealth is 6-7 times national income. The capital/income is 600-700%.
- But capital/income ratios tell us very little about the actual distribution of capital in a society i.e. who owns the wealth at an individual or household level.
- Remember, most people own nothing at all. In the US and Europe, 50% of the population own less than 5% of the wealth.

The R>G inequality

- Piketty proposes a new theoretical mechanism to analyze wealth inequality:

1. When the rate of return on capital (r) is equal to economic and income growth (g) then the capital/income ratio remains stable.

2. When the rate of return on capital (r) exceeds economic growth (g) then the capital/income ratio grows. Wealth accumulates.

- This is precisely what we observe in the USA and Europe since 1980. R>G leads to rising capital/income ratios. For Piketty, this suggests 'private capital is back'.

- Piketty finds that on average, in the long-run, economic growth averages 1-2%, whereas the rate of return on capital is 4-5%.

- R>G is the logical outcome of what happens when markets are left to their own devices. It is not a market imperfection!

- It was only during the fiscal revolutions associated with the social state in the 20th century did the inequality R>G go into reverse.

R>G

- Theoretically, a high capital/income ratio does not imply a high degree of inequality. All capital-wealth, in theory, could be distributed equally or held publicly.
  - But this is not the case.

- As we have seen throughout this course, in the USA the top decile own 72% of all wealth, whereas the bottom 50% own nothing at all.

- Be sure to study the distribution tables before your exam!!
  - Tables 7.1, 7.2, 7.3 in the book.

The inequality effect of R>G

But why does the mechanism R>G lead to increased concentration of wealth at the top of the income distribution?

1. First, wage inequality. Most people only earn enough to cover their living costs. They cannot save or invest. The higher your wage-income the more you one can consume whilst investing and saving the surplus.

   The wealthiest (0.1%) tend to invest in financial assets. The capital-income from these assets tends to accumulate and reap a high yield/interest rate.

2. Second, inheritance. The largest fortunes in market economies are usually inherited not earned. Bill Gates is a very rare phenomenon, and not representative of a general trend. The R>G effect works over the long-term.

The decline of inequality (a)

- Capitalist markets generate high levels of inequality. This is not in dispute. But why then did we witness a rapid decline in wealth and income inequality from 1950 to the 1980's?

- In the 18th century most capital-wealth was agrarian. Large landowners owned 90% of all wealth in European societies.

- There was no such thing as progressive taxation. Most fortunes were associated with inherited land or government bonds. In this period, capital/income ratios were rising because of the inequality R>G.

- In the 19th century capital was increasingly invested into industry not land. In Europe, most private capital was bound up with industrial assets and foreign assets accrued through colonization.

- In this period, although the composition of capital change dramatically, the capital/income ratios continue to rise because of the inequality R>G. A rising tide did not lift all boats. It created yachts for some.

The decline of inequality (b)

- From 1914 through to the interwar years, private capital experienced massive external shocks.
- Capital/income ratios declined because of physical destruction, government debt, inflation, the introduction of top income taxes, rent control and a whole raft of capital regulations.
- From WW2 until the 1980's there was a balance between private and public capital, which gave birth to national varieties of capitalism.
- This was the birth of the democratic state, where revenue and expenditure shifted toward providing income transfers (pensions) and public services (healthcare and education) to all citizens.
- In the 20th century economic growth exceeded or balanced capital-income growth. This was the period of a "rising tide lifting all boats”.

In summary…

- The decline in inequality took the shock of two world wars, followed by a soft revolution in the fiscal policies associated with the democratic social state, collective bargaining and trade unionism. There was nothing "natural" about this market process. It was the outcome of a political struggle between different “class interests”.

The rise of 'neoliberalism'.

- From the 1980's onwards most countries were exposed to international financial globalization. There was a shift back to private capital, particularly financial capital.
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- In response to the oil crisis and overburdened welfare states, the Keynesian demand management 'consensus' came to and end.
- Public policies and institutions shifted toward privatization and re-regulation for market outcomes, particularly in international capital markets.
- Economic and income growth slowed down, whilst the capital incomes of those owning financial assets (wealth) soared i.e. R>G.
- The accumulation of capital-income ratios has meant inheritance has re-emerged as crucial factor in determining who owns wealth, and who does not.
- Public opinion and belief systems have become much more tolerant of inequalities (because they are perceived as a just outcome of individual merit and talent).
- The shorthand to describe these changes is ‘globalization’ or ‘liberalization’.

Distribution tables

- Piketty uses social distribution tables to wealth and income distribution from the 18th-21st century.
- These give us a much more visceral understanding of inequality and distinct measures from the Gini coefficient.
- His data suggests that we must observe changes in the top top centile of the income distribution, as this is where most of the radical changes have taken place.
- Most of the income and wealth gains since 1980 have accrued to the top 0.1 percent of the population. Gini coefficients cannot capture this oligarchic trend.

Why does this matter?

- Piketty does not get into a normative discussion on questions of fairness or social justice. But have a look at John Rawls.
- He simply points out that even if you think differences in wage income and capital accumulation are justified, it is hard to legitimate a situation where inheritance matters more than merit.
- He also warns us about the dangers to democracy in a society completely dominated by private capital, particularly when the latter is concentrated in the hands of the top 1 percent.
- He also highlights the distributive implications (and irony) of austerity and public debt in European societies rich in private wealth.
- His solution to stem the rise of economic inequality, and to avoid the worst effects of R>G, is to impose a coordinated and progressive global wealth tax (including corporate profit).

Conclusion

- The conditions under which a coordinated wealth-capital tax can be implemented is a question for political science.
- It requires an extremely high level of international cooperation to overcome collective action problems.
- The most likely place it could occur is in the EU. But such cooperation is undermined by growing tax competition between nation-states.
- In Europe, this capital tax should be used, according to Piketty, to pay off the public debt of those sovereign states who stepped in to save the banking and financial sector from collapse during the Euro crisis.
- He also argues that capital-taxes should be used to raise revenue to invest in education, research and public infrastructure.
- In the absence of international cooperation to regulate global capital in the 21st century Piketty anticipates a rise in support for protectionist, nationalist, right wing, and anti-European political parties.
- This implies that economic inequalities are the source of rising extremist politics.

The end…..

- This brings us to the end of our lecture series.
- Best of luck in the exams, and the rest of your studies.
- At least in university, the price of success is hard work!