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Piketty on Capitalism and Inequality: A Radical Economics Perspective

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Abstract

Thomas Piketty's *Capital in the Twenty-first Century* has focused attention on the dramatic rise in economic inequality that has occurred in the United States and Europe over the past four decades. This paper argues that his account of the mechanisms that determine the distribution of income and wealth in a capitalist economy is unconvincing, for it rests on a tautology and on a spurious hypothesis about how the savings rate, the growth rate, and the capital/income ratio are connected.

JEL Classification: D31, N30, P10

Keywords

Piketty, income inequality, distribution, capital

A paradox underpins the political-economic discourse of the past three decades. Despite more or less persistent growth in labor productivity over the period, the idea has somehow taken root that advanced capitalism is no longer capable of generating rising living standards for a substantial portion of the population. According to the new model, wage-earners will have to get used to "working longer for less," as a *New York Times* reporter put it nearly two decades ago (Cowell 1997). In the aftermath of the 2008 financial collapse, the dominant view among policymakers has been that some reduction in the average standard of living is necessary and in any case inevitable for Europe and North America.

So certain are political elites of this outcome that they have taken steps to facilitate it by imposing austerity measures that are bound to inflict immense hardship on millions of people. The fruit of such measures is already being harvested in Europe, where growth has stagnated and joblessness remains at historically high levels. In the United States the 2007-09 recession is routinely described as the worst in thirty years; we are less often reminded that the recovery from it has been the most anemic in the nation's history, judged according to the post-crisis growth rate and by the length of time the economy needed to regain the level of employment that existed at the onset of the slump. The continued sluggishness of the U.S. economy is due in large part to the inadequacy of the stimulus program enacted in 2009; alarmist concerns about deficit spending

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and the national debt make further stimulus measures unlikely, even though the American Recovery and Investment Act expired at the end of 2011 and the state of the U.S. economy can hardly be described as robust. And while the Obama administration acknowledges that fiscal contraction would be counterproductive until an assured recovery is well under way, it does not question the need for fiscal restraint once the present crisis has passed.

The view that widely shared prosperity is no longer affordable, that we have not the wherewithal to maintain the social programs and infrastructure spending that were once within our means, is both mathematically and rhetorically paradoxical. The mathematical paradox is that rising output per worker, by definition, entails the possibility of a net increase in economic welfare, a point that has been well understood since the time of Adam Smith. Rising labor productivity enables increases in *per capita* income, and an economy that is generating more real output per person is certainly capable of providing greater material wellbeing to its population. A welfare state that was once affordable will not become unaffordable, and living standards need not decline, unless the economy experiences negative productivity growth, a highly unusual event.[1] The rhetorical paradox lies in the conventional insistence that market economies are reliable deliverers of rising prosperity; if that is so, how has it come about that the defining features of middle-class prosperity—steady employment at high wages, access to decent public schools, affordable healthcare, and expectations of a comfortable retirement, among many other things I might mention—are being eroded by allegedly irresistible market forces?

Now comes Thomas Piketty's immensely successful *Capital in the Twenty-first Century* (2014). The book has focused attention on the explosion of income inequality that has occurred since the postwar golden age came to an end in the early 1970s. Piketty contends that the rise of inequality is an embedded feature of the normal functioning of capitalism; the postwar episode, in which both labor and capital shared in the benefits of productivity growth, was an exception and is unlikely to be repeated in the foreseeable future.

The first question that comes to mind when contemplating Piketty's findings is why such an enormous fuss has been made over a book that says, in sprawling and meticulous detail, what everyone already knows. This is not to disparage Piketty's achievement: he has distilled a tremendous amount of data into an impressive, if not altogether tractable, story. But what has drawn attention is his point that wealth and income have become more unequally distributed over the past thirty years. This is hardly a new revelation. The trend was evident by the end of the 1980s, and has been explored by Edward N. Wolff (1995), Richard B. Freeman (1999), and A. B. Atkinson (2008), among others. The internet abounds with links to studies showing rising Gini indexes and declining wage shares in virtually every advanced capitalist economy since 1980. Piketty's book is notable for the sheer immensity of its number-crunching ambitions; it is a useful but not a groundbreaking work.[2]

Global capitalism has been performing badly enough over the past decade and a half to raise concerns about whether it will ever again function in a way that reliably generates a decent standard of living for most people. There is widespread anxiety about whether policymakers can figure out how to get the system to function the way it did during *les trente glorieuses*. By examining patterns of data over long stretches of time, Piketty formulates a hypothesis to explain why some periods experience rising concentration of wealth and income while others are characterized by decreasing inequality. His hypothesis does not question the general efficacy of capitalism or consider whether an alternative system might be both viable and more desirable, or even whether capitalism ought to be radically reconfigured. The observed patterns are, he argues,

[1]One indicator of the severity of the global economic downturn triggered by the financial crisis of 2007-08 is that a number of developed economies, notably the UK, experienced several years of negative productivity growth (see Barnett *et al.* 2014).

[2]For a different perspective see Milanovic (2014), who considers the book a "watershed" contribution.

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regulated by deeply embedded historical tendencies. Policy adjustments may produce better (or worse) socioeconomic outcomes, but the fundamental trends cannot be molded to our will. Piketty (98-99) explicitly rejects the hypothesis that the triumph of neoliberalism after 1980 was a significant factor in the rise of inequality. At the same time, he acknowledges that the rise of inequality is dysfunctional, and he questions the orthodox supposition that income disparities reflect differentials in talent among individuals and hence lead to improvements in social welfare. There's something here for everyone. Piketty tackles a problem that is, just at the moment, difficult to ignore; but he treads with caution on the question of how much reform is necessary to get morally acceptable results from modern capitalism. The book was published by a major university press with great fanfare, and, one presumes, a larger-than-usual promotional budget for a technical work on an economic topic. Hence all the attention.

Like many ambitious works, Piketty's book is unwieldy and, in parts, rather messy. No brief essay could dissect its many intricate claims. I shall therefore focus on aspects of Piketty's argument that strike me as particularly noteworthy or problematic.

It is first of all important to keep in mind that when Piketty uses the word "capital" he essentially means wealth expressed as a sum of monetary value, including: the value of physical plant and equipment; financial assets such as common stock, corporate and government bonds, bank balances, and pension funds; residential real estate; and the value of land and natural resources. The capital of Piketty's title is therefore not the factor of production that is utilized in combination with labor to generate the economy's net product. He offers a decidedly weak rationale for adopting this definition: "Capital in all its forms has always played a dual role, as both a store of value and a factor of production. I therefore decided that it was simpler not to impose a rigid distinction between wealth and capital" (48). But the peculiarity and inaptness of his definition become evident when he defines national capital as the total value of farmland + housing + other domestic capital + net foreign capital (119). Thus the capital that employs workers, *i.e.* the capital that matters to capitalism, that defines the system and distinguishes it from other forms of socioeconomic organization, is lumped under the heading of "other domestic capital"![3] Furthermore, Piketty's rate of return on "capital" is calculated on the basis of all assets comprising private wealth, including demand deposits and cash, which have no yield; time deposits, which generally have very low yields; and government-issued securities, which also tend to have low yields. The inclusion of bank balances may be of little importance to Piketty's conclusions since, as he notes (209), these low-return assets account for a tiny fraction of total wealth. It is not so evident that the same can be said of low-yield government bonds, however.

A distinctive feature of Piketty's book is that whenever he enters into a discussion of theoretical issues his analysis becomes wobbly. He is very good at evaluating empirical evidence; but when he turns to theoretical matters he appears to be out of his element. He puts forth a grand hypothesis but is unable to provide a robust theoretical grounding for it.

The long first part of the book is concerned with the behavior of the aggregate capital/income ratio ($\beta = K/Y$) over long stretches of time. This ratio appears to have been flat from the 18th century to the early 20th century, then u-shaped from around 1910 to the present, with the nadir occurring around 1950. By now Piketty's argument is pretty familiar. He posits the existence of what he calls the first fundamental law of capitalism, which he expresses as:

$$\alpha = r\beta$$

[3]Marx's (1894: ch. 29) concept of fictitious capital has a bearing on how one measures the capital stock. In recent decades, credit-fueled speculative bubbles in the markets for equities and real estate have artificially amplified the value of asset portfolios. Piketty recognizes that such phenomena complicate the measurement of wealth, but he maintains that they pose no serious difficulties for discerning meaningful patterns in the data.

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where $\alpha = \pi/Y$ is the share of income from capital (π) in national income (Y), and r is the rate of return on capital. The expression, Piketty notes, is an identity, a tautology.[4] Yet he contends that it is fundamental "because it expresses a simple, transparent relationship among *the three most important concepts for analyzing the capitalist system*: the capital/income ratio, the share of capital in income, and the rate of return on capital" (52; emphasis added). But he never explains why he assigns central importance to the capital/income ratio rather than to, say, the wage share. Piketty does remark that "For the eighteenth and nineteenth centuries, estimates of the value of the capital stock are probably more accurate than estimates of the flows of income from labor and capital. This remains largely true today. That is why I chose to emphasize the evolution of the capital/income ratio rather than the capital-labor split, as most economic researchers have done in the past" (204). This is hardly a persuasive reason to focus on the capital/income ratio as an indicator of "the overall importance of capital in society" (51); it is akin to looking for a lost set of keys underneath a streetlamp because the light is better there.

It may very well be true that for the 18th century and most of the 19th century, data on wealth are more readily available than data on income. But reliable income data have been available since the early 20th century. Moreover, the wage share is a far more transparent datum than the capital/income share; there is no ambiguity about what the wage share means or what its movement over time tells us about how different social classes are faring relative to one another. The capital/income ratio, on the other hand, is fraught with ambiguity, beginning with the problem of how to measure capital. Piketty ignores a rather basic circularity problem: that is, that the value of the capital stock is sensitive to the interest rate used to discount future returns; hence his r and his β are not strictly independent of one another. At one point, Piketty (53) remarks upon some difficulties that might complicate the measurement of β, and then goes on to suggest that in such instances "the least imperfect method of measuring the capital share of income may be to apply a plausible average rate of return to the capital/income ratio," as though the appropriate "plausible average rate of return" is knowable *a priori*. This is not a problem from the standpoint of his fundamental identity; but it is a problem when he tries to tell a story about causality on the basis of that identity.

Piketty connects the growth rate of the economy to the evolution of the capital/income ratio over time. His hypothesis is that when an economy finds itself in a low-growth regime, defined as a situation in which the growth rate is below the rate of return on capital, then the capital/income ratio will rise. This he derives from a "second fundamental law of capitalism," according to which "the higher the savings rate and the lower the growth rate, the higher the capital/income ratio" (55). The second fundamental law is captured by the expression:

$$\beta = s / g$$

where s is the overall savings rate of the economy and g is the growth rate of aggregate output. The rationale behind the equation is murky. The mathematics are straightforward if we presume that aggregate saving S is definitionally equal to aggregate investment I: $s/g = (S/Y)/(I/K) = (S/Y)\cdot(K/I)$, which is equal to $\beta = K/Y$ only if $I = S$. The relationship, Piketty writes, "reflects an obvious but important point: a country that saves a lot and grows slowly will over the long run accumulate an enormous stock of capital (relative to its income), which can in turn have a significant effect on the social structure and distribution of wealth" (166). But if saving and investment must match for the equation to hold, it is difficult to see how an economy can save a lot yet grow slowly; if all savings are channeled into investment, a high savings rate should translate into a high growth rate.

A bit further on Piketty explains that this second fundamental law applies only over the long run and "only if certain assumptions are satisfied" (168). The savings rate and the growth rate must remain more or less constant over a long stretch of time in order for an economy to settle

[4]By definition $r = \pi/K$. Since $\beta = K/Y$, it follows that $r\beta = (\pi/K)\cdot(K/Y) = \pi/Y = \alpha$.

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into the long-period equilibrium state defined by $\beta = s/g$. But of course neither s nor g is a constant. Piketty acknowledges that this "equilibrium state is never perfectly realized in practice" (169). That is fair enough: no equilibrium is ever "perfectly realized in practice." But in what sense is a fundamental law that need not hold actually fundamental? And what relevance does it have? Piketty goes on to argue that the second fundamental law

> is valid only if asset prices evolve on average in the same way as consumer prices. If the price of real estate or stocks rises faster than other prices, then the ratio β between the market value of national capital and the annual flow of national income can again be quite high without the addition of any new savings. … If we assume, however, that price variations balance out over the long run, then the law $\beta = s/g$ is necessarily [!] valid….

The first fundamental law is a tautology; the status of the second fundamental law is utterly opaque: it "applies in all cases" (170), but only under certain circumstances.

In any event, Piketty provides no robust explanation for why β must rise if $r > g$. His argument appears to rest on the presumption that we can legitimately treat both s and r as parametric, the first being a behavioral constant and the second a structural norm of some sort. That leaves the growth rate as the only causal variable that can change. If we start from a situation in which $r = g$, then a decline in g below r must cause the capital/income ratio β to rise, given the second fundamental law. But Piketty presents no formal integration of his two fundamental laws to derive his conclusion about the relation of r and g to β. An attempt at such an integration suggests that his conclusion does not mesh with his arithmetic. Since Piketty's first fundamental law is an identity and his second fundamental law expresses (he posits) a necessary long-run tendency, it follows that in the long run:

$$\beta = \alpha / r = s / g.$$

In other words, in the long run the ratio α/r cannot diverge from the ratio s/g, since both ratios must equal β. Let us again start from a situation in which r and g are equal.[5] If now the growth rate declines, falling below r, either (i) β rises, as Piketty predicts, but then something must happen to the elements of α/r (r must fall or α rise) or the first fundamental law will be violated; or (ii) α and r do not adjust, in which case β cannot change either because of the first fundamental law, and so the savings rate s (hitherto presumed to be a behavioral constant) must decline to keep the ratio s/g unaltered. My point is that Piketty's fundamental laws are not very useful for understanding historical trends: the first law is an identity that cannot tell us much about causality; and the causal linkages among the variables that comprise the second law are never articulated by Piketty in any systematic way.[6]

There is a strong "reversion to the mean" element to Piketty's argument about the determination of β. From his empirical analysis he derives estimates of the long-run normal values of his fundamental variables: $\beta = 6$; $r = 0.05$; and therefore $\alpha = 0.30$. But why these should be the normal values is not made clear. One might well presume that, owing to technical change, which largely takes the form of increased mechanization, β would have a tendency to rise over time. Why it appears to have remained roughly stable in the neighborhood of 5 or 6, except for the mid-20th century dip, is left unexplained.

[5]This implies that the economy's savings rate s and the profit share α must also tend to be equal in the long run (since α/r and s/g must both equal β), which in turn implies that capitalists save all of their profits and workers save nothing out of their wages. Piketty appears not to have noticed this.

[6]See Bernardo, Martínez, and Stockhammer (2014) for a Post-Keynesian critique of Piketty's effort to link the capital/income ratio, the profit rate, the growth rate, and the savings ratio.

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The postwar golden age was a deviation from the norm, the result of a unique set of factors—or shocks, as Piketty sometimes calls them—that occurred during the 20th century. The two World Wars destroyed an enormous amount of capital. So did the huge wave of bankruptcies that characterized the Great Depression. Various public policies, such as rent regulations and nationalization of certain industries, had the effect of reducing the value of privately owned capital. And high inflation eroded the real value of assets and of the interest paid to rentiers. These factors, Piketty argues (275), contributed to a decrease in the capital/income ratio, and hence to a decline in the share of income from property in national income. But the shift was merely temporary, an aberration that gave rise to "the illusion that capitalism had been structurally transformed" (118). The great irony of Piketty's book is that, even as he insists on the primacy of historical forces, he concludes that, in the end, those forces have had no permanent impact on the structure of capitalism.

In line with his historical approach, Piketty's attachment to the marginal productivity theory of distribution is at best perfunctory, and he emphatically rejects the idea that the current huge disparities in income can be justified on the ground that they enhance productive efficiency. This is all to the good. He is not prepared to throw the marginal productivity theory entirely overboard, however. He takes it for granted, for example, that "the marginal productivity of capital decreases as the stock of capital increases," and he goes on to surmise that the return on capital must decline as well (215-218), though this position seems to be somewhat at odds with his contention that the return on capital is a historical constant in the neighborhood of 5 percent.[7] Piketty mistrusts the Cobb-Douglas production function, and seems to have an inkling of the logic of Anwar Shaikh's HUMBUG production function, though he does not cite Shaikh (1974). But he thoroughly misunderstands the gist of the capital controversy. Though skeptical of the marginal productivity theory, Piketty never puts forward an explicit account of what regulates wages.

It is also noteworthy that Piketty has nothing to say about Keynes or Keynesian demand management policy, even though it might plausibly be argued that the adoption of such policies in the quarter century that followed the Second World War was an important factor in buttressing worker bargaining power, and that the abandonment by policymakers of a commitment to full employment in the neoliberal period led to a traumatization of the working class that prevented pushback against the reduction of middle-class living standards. Piketty does not pay much attention to the connection between rising inequality and the problem of realizing profits; the owners of capital must be able to sell the goods and services their workers produce, but this is difficult to accomplish if at the same time capital is doing everything in its power to erode the living standards of workers. When Piketty worries about the sustainability of current trends he mainly has in mind the specter of political instability. But the economic contradictions caused by the continued squeeze on workers' purchasing power may manifest themselves first.

What is missing from Piketty's story is a role for class conflict. Occasionally he acknowledges a conflictual element in capitalist economic relations, but he mostly notes that element in passing. He rejects the neoliberal mantra that giving greater scope to market forces will "ensure a just, prosperous, and harmonious society" (30). And he sees a role for policy measures to address the problem of inequality. But he is mainly interested in establishing the empirical grounding of "laws of cumulative growth and cumulative returns" that he believes account for inequality.

Piketty understands that current income disparities are socially destabilizing. His analysis points to a relentless trend of increasing concentration of income and wealth, with consequences that he aptly describes as "potentially terrifying." In the face of this dire prognosis, his policy recommendations seem tepid. He advocates strengthening the welfare state at the national level,

[7]Recall also that Piketty's conception of "capital" is a hodgepodge of physical and financial assets expressed as a sum of monetary value. Why the magnitude of that sum should bear any systematic relation to aggregate output is not at all evident. Equally unclear is what is to be understood by the marginal productivity of that sum.

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and a global wealth tax. These are sensible suggestions. But they do not address the dynamic forces that are driving inequality; they merely ameliorate the human damage caused by those forces. Piketty is hesitant to confront the full implications of his conclusions: if capitalism has a structural disposition to generate socially dysfunctional levels of inequality, a genuine remedy will be found only in radical structural transformation.

We deem economic inequality to be a problem not so much because it is bad in itself (though it may be) but because under capitalism the mechanisms that generate inequality do so by inflicting grave harm on large numbers of people. Income and wealth are more easily channeled upward when worker bargaining power is weak: when governments abandon the commitment to maintain full employment; when financial markets serve mainly to concentrate wealth at the expense of worker wellbeing and long-run growth; when social safety nets are weakened or eliminated; when labor laws are repealed or not enforced. Of these things Piketty has little to say. The United States is purportedly in an economic recovery; but more than 100 percent of the income gained since the economy began its climb out of the trough has gone to the most affluent 10 percent of households, that is, the income gains of the most affluent were achieved by the infliction of a decline in the living standards of the remaining 90 percent of households (see Tcherneva 2014). This cannot be explained by Piketty's laws of cumulative growth and cumulative returns. *Capitalism in the Twenty-first Century* is an impressive work of statistical analysis. But it does not fulfill its promise; for all its ambition, it is not ambitious enough.

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