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Piketty and the resurgence of patrimonial capitalism

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The wave of media enthusiasm and academic interest that has surrounded the publication of Thomas Piketty's massive tome reflects a wider resurgence of public interest in and concern with inequality. Over the last few years in particular, a significant and growing number of reports of international organizations[1], academic treatises[2] and more popularly oriented books[3] have dealt with this subject, at global, regional and national levels. The greater attention that Piketty's work has received may have come as a surprise to some, but it is certainly nonetheless greatly to be welcomed, as everything that draws highlights and gives prominence to this critical recent trend of growing inequality across most economies is important.

The empirical work of Piketty (together with others such as Emmanuel Saez and others using the Global Top Income Database that they have developed) has already been a resource of much value for both academics and policy makers for some time now. The book brings together much of this work, but also adds to it by seeking to provide an explanation of the broad trends uncovered by the empirical study.

The recognition that broad measures of inequality such as the Gini coefficient relying on periodic surveys of income or consumption provide at best a limited and sometimes even misleading idea of true inequality is an important insight. The creative use of tax returns to derive income shares of total national income across the population, particularly at the top, is another major contribution of this work. The focus on the shares received by top incomes – of the top percentile and on occasion the top 0.1 per cent – generates significant and even startling conclusions that support in often dramatic fashion the popular perceptions of the "Occupy" and similar movements. The spotlight on asset inequality, and particularly on the role of inheritance, is revealing. The insights on the competing claims of "patrimonial" versus "meritocratic" sources of inequality are rewarding.

The ambition and effort required to unearth such data over a longer historical sweep, in some cases several centuries using whatever different sources can be put together, is also of major interest and provides a longer term perspective on these issues that is often lost in an examination of just the past few decades, even if in some cases the consequent generalizations are somewhat too sweeping and therefore problematic. And of course the book (even in English translation) is very well-written and absorbing, with many literary references (dominantly Jane Austen and Balzac, but also bits of popular culture like the television series "Mad Men") thrown in for added interest and to drive certain points home in a telling way.

The historical/empirical points made by Piketty are both striking and persuasively presented. They are most conveniently summarized in the now-famous U-shaped curves that he

[1] For example, UN (2013); UNCTAD (2011); UNICEF and UN Women (2013); OECD (2008); World Bank (2006); ILO (2008); even IMF (2007).
[2] To name just a few, Milanovic (2005, 2011); Cornia (2011, 2013); Galbraith (2012); Khan (2012); Lim (2013).
[3] Such as Wilkinson and Pickett (2010), Cohen (2008).

describes for the income and asset shares of the top decile and the top percentile of the population (and even the top 0.1 per cent in some instances) in developed capitalist economies. These indicate relatively high inequality (expressed as high shares of these top income groups in total national income) in the early part of the 20th century, followed by a period of decline particularly during and after the second World War, and then a surge in inequality from around 1980 to the present, in some instances far surpassing even the high inequality observed in the late 19th/early 20th centuries.

The main contribution of the book – beyond the body of impressive historical and empirical research that has been published by Piketty and his colleagues in several articles – is the attempt to explain these observed patterns through a broad theory of long run capitalist development that is then also used to explain tendencies in contemporary capitalism. This is an ambitious task indeed, especially when it is evident that Piketty's conceptual framework is implicitly confined by a limited and ultimately ahistorical neoclassical approach towards the distribution of income shares.

Piketty is clearly conscious of the complexity of the various forces that determine economic inequality. He notes (p. 20)[4] that "one should be wary of any economic determinism in regard to inequalities of wealth and income" since this has always been deeply political. He also notes that "the dynamics of wealth distribution reveal powerful mechanisms pushing alternately toward convergence and divergence", and "there is no natural, spontaneous process to prevent destabilizing, inegalitarian forces from prevailing permanently". Notwithstanding these warnings, he then proceeds to make a very economically deterministic generalization about a basic tendency of capitalism, which he posits as "the fundamental force for divergence".

This is the argument that $r > g$, where r is the annual rate of return on capital expressed as a percentage of its total value, and g is the (presumably real) rate of growth of national income. He notes (much in the spirit of Evsey Domar) that "when the rate of return on capital significantly exceeds the growth rate of the economy… then it logically follows that inherited wealth grows faster than output and income" (p. 26). Furthermore, this tendency is then reinforced by other mechanisms, such as the savings ratio of the economy increasing as wealth increases. Since "the share of capital in national income is equal to the product of the return on capital and the capital/income ratio" and "the capital/income ratio is equal in the long run to the savings rate divided by the growth rate" (p. 33), we effectively get a steady growth path in which both the capital/income ratio and the income share of those who own capital and receive a return from it keep increasing. Implicit in this argument is a theoretical model in which capital and labour are factors of production that are paid their marginal products.

The question obviously arises: what explains this supposed "law" of capitalist development? Piketty argues that growth rates of the economy tend to decrease particularly as population growth slows (thereby implicitly assuming some sort of full employment growth path in which exogenously determined population growth forms the "natural" rate of growth) but there is no equivalent decline in the rate of return on capital. This is a problematic argument for many reasons. For example it assumes that full employment prevails on this growth path (at least in a long run sense) and that labour supply is exogenous, unlike the historical experience that has shown us that capitalism has always generated a supply of labour to adjust to demand, whether through migration or the changing work participation of women and children, or other means. Indeed, this formulation, relying on the ultimate determination of growth through

[4] All page numbers for Piketty relate to the Kindle edition of the book.

exogenously given population growth and exogenous technological progress, is rejected by almost all modern growth theory, as Patnaik (2014) has pointed out in a very insightful critique.

This treatment of capital also ignores all the problems associated with the measurement of capital, which were highlighted by Piero Sraffa (1966) and others. Piketty himself seems blissfully unaware of the fundamental analytical challenge posed by this position, which pointed out that when capital is seen as a sum of values, the determination of these values or prices requires that distribution (including the profit rate) is already known. Therefore any attempt to determine profit as a marginal product of capital is circular and invalid (Bharadwaj, 1968). Simply put, you cannot explain something in terms of itself. Instead of recognising this basic critique, Piketty blithely describes the Cambridge controversies on capital as the result of the mistaken belief of economists in Cambridge England (such as Joan Robinson, Nicholas Kaldor and Luigi Pasinetti) that the Solow model argued that growth is always perfectly balanced. This is a completely wrong interpretation of their position that leaves out their basic argument. Piketty further states that by the 1970s, "Solow's so-called neoclassical growth model definitively carried the day" (p. 231). But indeed, Solow himself conceded the theoretical battle in the late 1960s, and most serious growth theorists today, especially those using endogenous growth theories, do not use the Solow model. And in any case, just because the mainstream profession has chosen to ignore this logical problem does not mean that it no longer exists.

On a steady growth path, Piketty's claim for the continuous increase in the capital/income ratio requires that the income elasticity of substitution of capital for labour is greater than unity – and indeed Piketty argues that it has historically been between 1.3 and 1.6. However, it has been pointed out that this assumption is questionable and furthermore is not actually supported empirically (Rowthorn, 2014; Semeniuk, 2014). Even more crucially, Patnaik (2014) has shown that a stable steady state trajectory, where the growth rate equals the sum of the exogenous rate of growth of the workforce and the exogenous rate of growth of labour productivity *does not exist* when the elasticity of substitution between capital and labour exceeds unity.

Neither is there strong evidence for the statement that the capital/income ratio continuously rises, since this also depends crucially on how capital is valued. Rowthorn (2014) has correctly argued that this is probably the result of a valuation effect reflecting a disproportionate increase in the market value of certain real assets, especially housing and real estate. Indeed it could be noted that the very fact that Piketty provides a U-shaped curve also for the capital/income ratio undermines his own argument, for at least on the downward slope of the U curve there was clearly a period (a fairly prolonged period of more than half a century, as it happens) when the capital/income ratio declined!

Piketty's own explanation for the downward-sloping portion of the curves (the period when the incomes shares of the top decile or percentile came down, or when the estimated ration of capital to income declined) is less than satisfactory. He sees the downward movement as something of a historical aberration from the opposite long-term trend, the result of the collapse of capital values (related to both the destruction of physical equipment and the decline in prices of financial assets) because of wars, depression and socio-political changes after the Second World War. But this explanation is both partial and unconvincing: as Galbraith (2014) has pointed out, physical and price changes are indeed very different and cannot be treated as aspects of the same thing. Further, the post-war improvements in labour

shares of income in many developed capitalist economies were due to significant social and political changes, reflecting Piketty's own more nuanced formulation in an earlier chapter, that income and asset distributions reflect more than material forces but also political and cultural forces in society. And the prolonged period of the downward part of the curve does undermine the notion that – at least as expressed empirically in historically observed patterns – this is a necessary aspect of capitalist growth.

But what exactly is capital for Piketty, and what is the rate of return that he is talking about? Piketty uses the terms "capital" and "wealth" interchangeably, and defines them very broadly: "the sum total of nonhuman assets that can be owned and exchanged on some market. Capital includes all forms of real property (including residential real estate) as well as financial and professional capital (plants, infrastructure, machinery, patents and so on) used by firms and government agencies" (p. 45). So it includes "all forms of wealth that individuals (or groups of individuals) can own and that can be transferred or traded through the market on a permanent basis. … Capital is not an immutable concept: it reflects the state of development and prevailing social relations of each society" (p. 46).

This brings to mind Marx's conception of capital as a social relation, though such a comparison would no doubt horrify the author. Capital here is also defined as including patents and other forms of intellectual property and similar "immaterial" forms such as stock market valuation, which therefore incorporates the changing valuations of both physical and financial assets by markets. But treating capital in this manner as a sum of prevailing values that reflect prevailing social relations sits very uneasily with the idea of the return on capital being in some sense its "marginal product", which is the underlying conceptual basis for his theoretical formulation. In particular, the very notion of the marginal product of changes in, say, stock market valuation or housing prices, is analytically absurd.

And there is a further twist, when Piketty clarifies that the returns are simply the rents on capital, defined as "the income on capital, whether in the form of rent, interest, dividends, profits, royalties or any other legal category of revenue, provided that such income is simply remuneration for ownership of the asset, independent of any labour" (p. 422). How can this motley combination reflect a marginal product of an equally motley combination of tangible and intangible "assets", especially when problems of valuation are so extreme?

It takes a while for the reader to figure out that, despite the implicit requirement for a marginal productivity theory of distribution to provide some logical consistency to this supposed "law" of capitalist development, Piketty himself does not rely on this. It is not until page 361 that we finally get a clear statement of his admittedly slippery position on this most fundamental issue: "The inequality $r > g$ should be analysed as a historical reality dependent on a variety of mechanisms and *not as an absolute logical necessity*. It is the result of a confluence of forces, each largely independent of the others … g tends to be structurally low (generally not more than 1 per cent a year once the demographic transition is complete and the country reaches the world technological frontier, where the pace of innovation is fairly slow). … *r depends on many technological, psychological, social and cultural factors*, which together seem to result in a return of roughly 4-5 per cent (at any rate distinctly greater than 1 per cent)" (p. 361, emphases added).
At this point, the reader who has ploughed through the material in the vain hope of getting at a theoretical basis for this "law of capitalism" can be forgiven for thinking: WHAT???!!! All this fancy footwork, only to result in a vague and sweeping historical generalisation that makes no claims to logic, identifies no mechanisms of causation, but is only based on supposed "fact" –

and is anyway disproved for prolonged periods not just by the disparate experience of some capitalist countries but by the author's own data for different countries? With this bizarre (and surprisingly delayed) admission, Piketty may have sidestepped some of the criticism of the logical fallacies exposed by Patnaik, Rowthorn and others, but he does so at the cost of accepting that there is in fact no logic to his argument!

Supposing then, we forget about Piketty's theoretical claims (which now indeed appear to be rather brazen) and focus instead on the empirical and historical insights that he does provide. Of course there is scope for some disagreement about long run historical trends, especially when data on such issues for the very long run exist only for a handful of countries. But the aspect relating to the latter part of the past century up to the present is of particular interest: the rapid rise of the top income shares across several developed economies, albeit to different degrees (with the US and the UK providing the most extreme examples). This is corroborated by other careful empirical work (e.g. Stockhammer 2012, 2013) on the declining shares of wages in national income, as well as work (Cornia 2012, 2013) pointing to increases in wage inequality driven by incomes at the top of the spectrum that are really managerial in nature.

The decline in wage shares of national income, and the associated rise of "surplus" in various forms (which Piketty broadly refers to as returns to capital) has been explained along a variety of lines: the expansion of the "global" labour supply through greater trade integration and cross-border mobility of capital that have together dramatically reduced the bargaining power of labour; the labour-saving technological shifts that have had a similar effect; the dominance of finance or "financialisation" that have put inordinate power in the hands of financial players and influenced their ability to affect economic policies in their own favour. As Taylor (2014) notes, "the recent rise of the rentier has been supported by politics and policy marshalled to drive up the share of income going to profits."

In this context, Piketty's discussion of the significance of inheritance in driving the resurgence of "patrimonial capitalism" is indeed interesting and makes some insightful points. He points out that two competing determinants of inequality drive society's attitude towards it: the "meritocratic" notion that creates a society with superstar achievers or managers; and the "patrimonial" notion that is essentially based on inheritance. The two can coexist, and indeed there is a large grey area in between, even to the point that entrepreneurs (say Bill Gates) can turn into rentiers within a generation. But this also creates a basis for greater social acceptance of inequality. "If inequalities are seen as justified, say because they seem a consequence of choice by the rich to work harder or more efficiently than the poor, or because preventing the rich from earning more would inevitably harm the worst-off members of society, then it is perfectly possible for the concentration of income to set new historical records" (p. 263).

The much greater social acceptability of inequality in the US, for example, is probably based on this and results in extraordinarily high shares of the top 1 per cent, even when compared to otherwise similar economies in Western Europe. Yet despite this supposed justification, the US and other western economies are in reality all turning into more patrimonial societies, in which inherited wealth plays an ever growing role in determining the opportunities and future incomes of individuals, and concentration is aided not only by easier tax regimes but by exploitation by the rich of tax havens and similar loopholes.

To prevent or reduce this resurgence of patrimonial capitalism, Piketty calls for global and national taxes of wealth (earned but especially inherited) and on income from wealth. This is clearly a welcome call. It is true that the political conditions for such a goal to be realised are currently far from fertile. However, it is also the case that a number of developing countries (that are only cursorily dealt with in Piketty's enormous book) in Latin America and a handful in Asia and Africa have in recent years been able to reduce top income shares and increase wage shares of national income, for example through land redistribution, raising and enforcing minimum wages and improving the conditions for workers' associations that improve their bargaining power. The secondary distribution of income in several of these countries has improved even more, through a combination of fiscal strategies and policies towards control over natural resources that increase public revenues that can then be spent on social infrastructure and services as well as social protection. All this points to the possibility of several other strategies, including macroeconomic and industrial policies as well as other more structural policies.

So it is not impossible for country strategies to change, if the social consensus shifts decisively in favour of policies to reduce inequalities. But such political conditions will never be in place without wider support for such demands from not just academics but the wider public. It is essentially for that reason that the discussions around Piketty's book and other work that highlights the different dimensions of growing inequality are timely, important and even absolutely necessary.

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