BIENNIAL CONFERENCE OF THE ECONOMIC SOCIETY OF SOUTH AFRICA

SESSION B1

DISCUSSION PAPER

PIKETTY ON INEQUALITY – NEW LIGHT ON AN OLD STORY?

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2ND SEPTEMBER 2015

CAPE TOWN

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THE BIENNIAL CONFERENCE OF THE ECONOMIC SOCIETY OF SOUTH AFRICA (ESSA)

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DISCUSSION PAPER

PIKETTY ON INEQUALITY - NEW LIGHT ON AN OLD STORY?

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Abstract

This first discussion paper in the session on Thomas Piketty's 'Capital in the Twenty-First Century' is in two main parts. (1) summarises the broad conceptual and historical framework which Piketty uses to evolve his hypotheses on global inequality trends and outlines the extent to which his interpretation of economic history and research into tax records underpin his overall conviction that the advanced world has gone back to 19th century levels of inequality. It includes his assessment of the degree to which inheritance and escalating executive salaries over time perpetuate inequality. The forces of divergence perpetuating long term inequality are thus captured by Piketty in the private rate of return (r) being much higher than the rate of growth of income and output (g) i.e. (r) > (g). Piketty mainly offers an agenda of taxation to deal with it. (2) given Piketty's chief focus on advanced economies, developing countries have the potential of high 'catch up' growth to ameliorate inequality. Criticisms of Piketty to date has been mainly focused on the perceived vulnerabilities of (r) but not on the potential of strengthening (g). We examine SA's chances of avoiding Piketty's 'dystopian vision' of ever-widening inequalities, by seeking to make (g) > (r). Using Piketty's conceptual framework, it means that repairing the root causes of inequality in SA basically requires fixing the root causes of low growth by making (g) > (r). It is therefore necessary to examine to what extent the latest National Development Plan (NDP) meets the criteria for inclusive economic growth and the reduction of inequality. A potentially rich future research agenda could be generated by identifying alignments and divergences between the NDP and aspects of Piketty's work, given the acute challenges of growth and inequality in SA.

- ‘Economics is a science of thinking in terms of models joined to the art of choosing models which are relevant to the contemporary world’ – J.M. Keynes

- 'The true test of a scholar's work is the judgement that is made, not at the time his work is being done, but twenty five or fifty years later' - Milton Friedman

- Paul Krugman: 'I always think that when one's been carrying a theory too far, then is the time to carry it a little further'
  Thomas Piketty: 'a *little*? Good heavens, Paul! Are you growing old?' - Anon

1. Introduction

As the 2015 Biennial Conference of the Economic Society of South Africa (ESSA) is the first serious opportunity for many South African economists to engage with Thomas Piketty's 'Capital in the Twenty First Century' (2014) it is necessary to begin by briefly recapitulating the broad conceptual and historical framework which Piketty uses to sustain his overarching conviction that the advanced world has gone back to 19th century levels of inequality.

'Capital' is a capacious study of nearly 700 pages and it will only be possible to do limited justice to Piketty’s broad analysis of the dynamics of the accumulation and distribution of capital. (A subsequent paper in this ESSA session explores and challenges certain theoretical issues in the Piketty analysis and policy prescriptions).

Based on his extensive interpretation of economic history, together with research into past tax records over a long period, Piketty arrives at certain fundamental propositions. It might be said that Piketty’s analysis of economic history is not so much a study of a special class of facts, but rather a study of the facts from a special point of view.

Equality has now become a heightened theme in both global and national debates, especially since the 2008 financial crisis, and equality as an objective currently holds the field as one of the main issues of our time. Of course, both classical and neo-classical economists also had a great deal to say about inequality and poverty. ‘New economic thinking involves reading old books’ (Krugman, 2015). The quarrel between rich and poor is as old as the world. Concerns about the impact of economic inequality on social cohesion have given new urgency to moral questions about markets.

And while many other authoritative books and studies have appeared on the subject of inequality in recent years (for example, Sir Anthony Atkinson of the LSE has had a measure of inequality, the 'Atkinson Index', named after him) none have matched the global impact which Piketty's 'Capital' has had on recent thinking about inequality. The timing and presentation have been good.

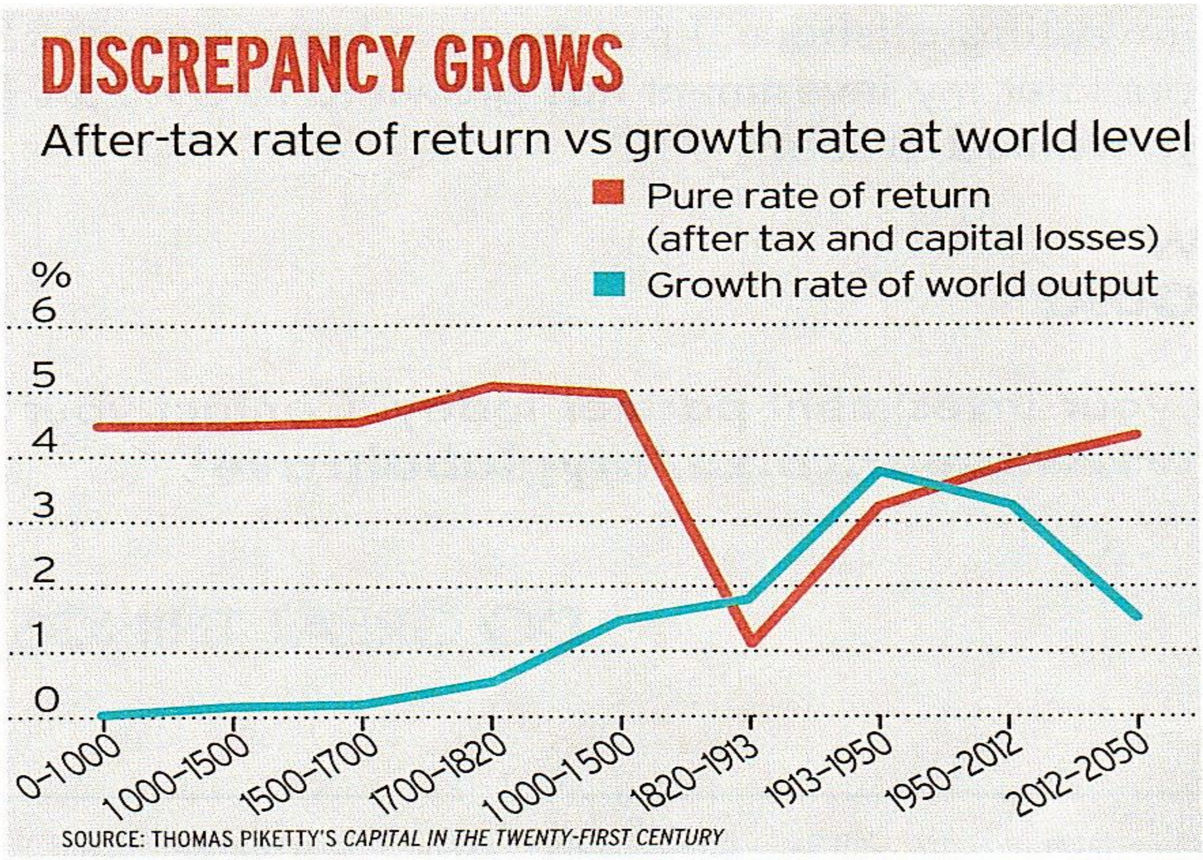
It provides an influential and organised (if controversial) framework for thinking differently about the evolution of wealth and income internationally. It is widely perceived as a seminal work both conceptually and in economic history. It fits into the intellectual and popular mood of the day. (His symbols (r) > (g) have even appeared on T-shirts!)

2. The Piketty Framework

Basically, Piketty asserts that, if 'capitalist systems' are left to their own devices, on present trends inequality will deepen and worsen as the 'rich get richer' over time, reinforced by globalization, inheritance and the large executive salaries of recent years. In his view, in mature economies the main driver of inequality has been unequal ownership of assets, rather than divergences in income. He sees the forces of divergence in the capitalist system which generate inequality as gaining the upper hand in recent decades, with negative consequences for democracy and societies as a whole. Contrary to standard economic theory, Piketty's inequality does *not* lessen over time. At the core of his policy prescriptions lies an agenda of taxation, both global and national, to rectify the situation. What then are the basic pillars of Piketty's case?

In simple terms it is as follows: where the rate of return on assets (stocks, bonds, real estate and other assets) is much higher than economic growth, this perpetuates inequality. In other words, where private return on capital (r) is significantly higher than the rate of growth of income and output (g), that is, (r) > (g), then wealth accumulated in the past grows more rapidly than output and wages. He argues that there are powerful mechanisms in the context of the basic dynamics of wealth distribution in the capitalist system which push alternately towards *convergence* and *divergence*.

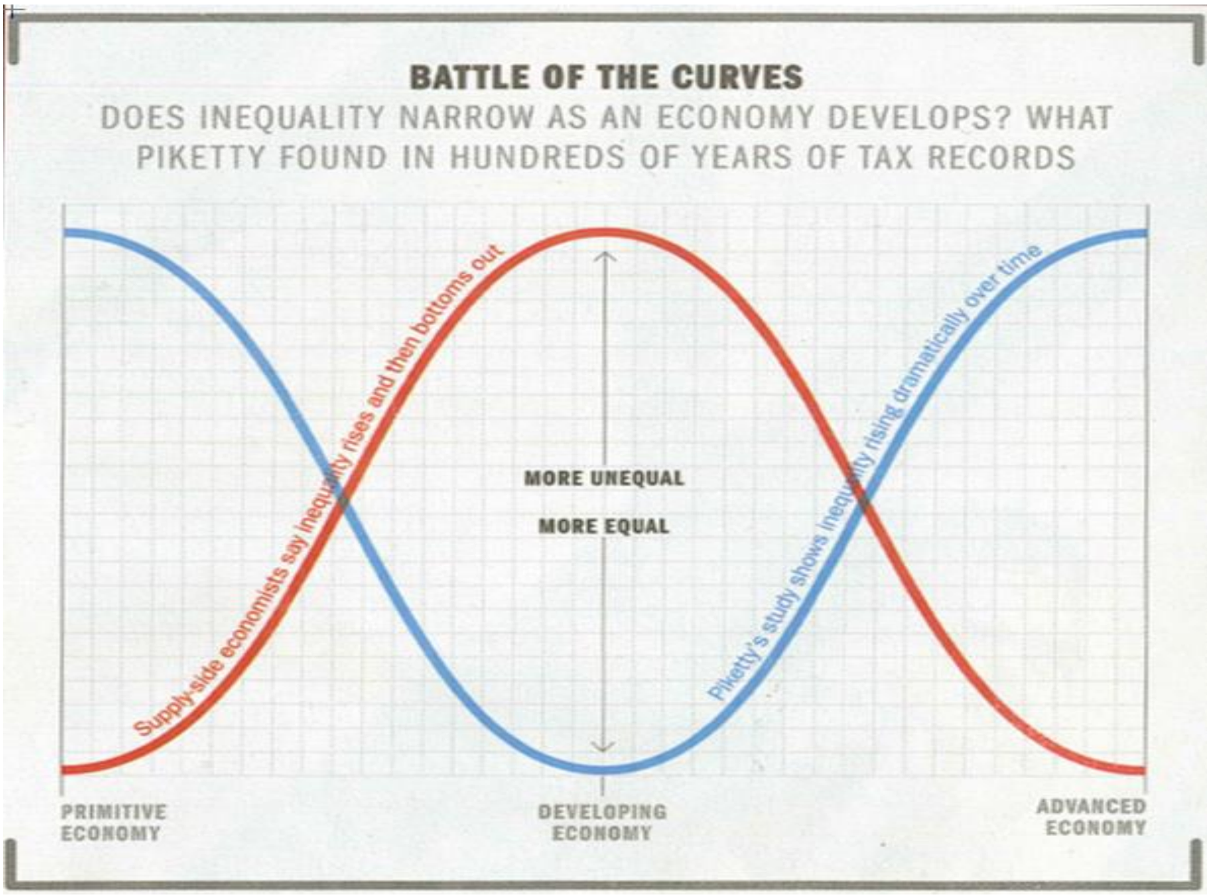
Knowledge and skill diffusion are the keys to overall productivity growth and a *convergence* towards greater equality will then prevail. But these have been overwhelmed by strong forces in the opposite direction, where there is instead *divergence* associated with the process of accumulation and concentration of wealth. Thus (r) > (g) is the 'the overall logic of my conclusions' says Piketty.



Piketty's view is that a rapid increase in inheritance flows, in the stock of inherited wealth and its concentration, have inevitably led to where top incomes from capital have predominated over top incomes from labour by a large margin. He sees 'skyrocketing' executive pay as also a major contributory factor to rising inequality, saying that globalization weighs most heavily on the least skilled in most countries and rewards the most highly talented excessively. In explaining why escalating top management remuneration occurred in some countries, but not in others, Piketty believes that institutional differences between countries are more important than technological change or productivity gains. He regards the rise of the 'super manager' as mainly an ‘Anglo-Saxon phenomenon.’

To counter these inequality trends Piketty urges mainly a rethink of top marginal tax rates - levying confiscatory tax rates (say 80%) on very high incomes (say, the top 5%) as the only way to stem the observed increase in extremely high salaries. He does, however, *not* seek taxing capital income to the point at which it damages the engines of accumulation and growth. Internationally, Piketty’s ideal tool would be a progressive global tax on capital (say, 0.1%), coupled with a high level of financial transparency, to help curb the excesses of what he calls 'patrimonial capitalism'. Piketty concedes that 'a global tax is a Utopian idea' but believes that there is great potential in promoting what he calls 'democratic and financial transparency' in addressing the political economy of global inequality.

In summary, therefore, the debate basically centres around Piketty's use of (r) > (g). Piketty argues that the growth rate of developed economies has been slowing, but that the return on capital is relatively undiminished. Since capital is concentrated in the hands of the wealthy, the existence of a long period in which returns exceed the growth rate leads to widening inequality. This can basically be countered only by higher taxes. 'I don't hate capitalism', says Piketty,' I just want to fix it'. (Piketty p 101). Piketty has thus given a new and strong impetus to the debate around inequality and capitalism, and has prominently and visibly entered the battleground of ideas on the subject.



Source: Economist, 23 April 2014.

3. Battleground of Ideas

How important *is* inequality? Some economists have been dismissive of distributional concerns. At the January 2015 Annual Conference of the American Economic Association in Boston Greg Mankiw gave his paper on Piketty the title 'yes, r > g, so what?' And a few years ago Robert Lucas expressed himself strongly as follows:

'Of the tendencies that are harmful to sound economics, the most seductive, and in my opinion, the most poisonous, is to focus on questions of distribution.....The potential for improving the lives of poor people by finding different ways of distributing current production is nothing compared to the apparently limitless potential of increasing production.' (Lucas, 2003)

To retain perspective we recall the well-known remarks made by Keynes (1936):

'The ideas of economists and politicians, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else. Practical men, who believe themselves to be quire exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back....sooner or later, it is ideas, not vested interests, which are dangerous for good or ill'

New ideas take root in soil which has been fertilized by social and economic trends, as well as by political events. The impact of the 'Great Recession' in 2008 has widened and deepened the economic debate, including on inequality. Ideas provide a template when the circumstances are right and pressure groups are either allies, or can be neutralised. Piketty's research now seeks to redefine the boundaries around growth and inequality at the right time. This requires vigorous engagement and proper vetting in what is a highly pertinent debate.

This is as true globally as it is for SA, and helps to explain why, in truth or error, Piketty's book offers a game-changing narrative to supporters and critics alike. Piketty's work itself remains a synthesis, in which the defects are often frequently inseparable from the merits. The Piketty diagnosis may be incomplete but not in its strategic reach and wider implications for policy.

Piketty's has been criticised on theoretical and empirical grounds, including:

- there is skepticism about 'general laws of capitalism'
- different theoretical perspectives on the relationship between (r) and (g)
- the law of diminishing returns in economics – 'Piketty seemed to have quietly *repealed* this law' (Stiglitz 2015)
- gross returns on capital ignore impact of depreciation
- inherited wealth is more unstable than claimed
- inequality looks different when housing is included
- the price of capital has been declining
- helping those at the bottom is more important than preoccupation with the size of the 'wealth gap'

It has become commonplace to say that many economists have accepted much of the Piketty 'message' but not all of Piketty's theoretical analysis. Can differences with Piketty's thinking be bridged? This is how Stiglitz approaches it:

'Here's how I attempt to square the circle posed by Piketty's argument: *if* we can avoid a bubble, returns to capital will *eventually* diminish enough that there will not be ever-increasing inequality - but the equilibrium inequality the economy arrives at may well be larger than today's already high and unacceptable level. There are a number of policies - practical policies that can be implemented by individual countries, even without international cooperation - that can lead to a lower level of equilibrium inequality. Many of the policies will actually result not only in lower inequality but in higher growth, because they will result in more *real* investment' (Stiglitz, 2015)

So intellectually is Piketty a 'hedgehog' or a 'fox'? In 1953 Oxford philosopher Isaiah Berlin published his famous essay 'the Hedgehog and the Fox'. Going back to a dictum attributed to the ancient Greek poet Archilochus 'the fox knows many things, but the hedgehog knows one big thing', Berlin applied the distinction to the difference between having one single defining idea versus having multiple perspectives. Over time Berlin himself was inclined to play down the dichotomy and not take it too seriously. Nevertheless, famous as it has become, could Piketty perhaps be mischievously characterized as the hedgehog in this debate, with his critics as the foxes?

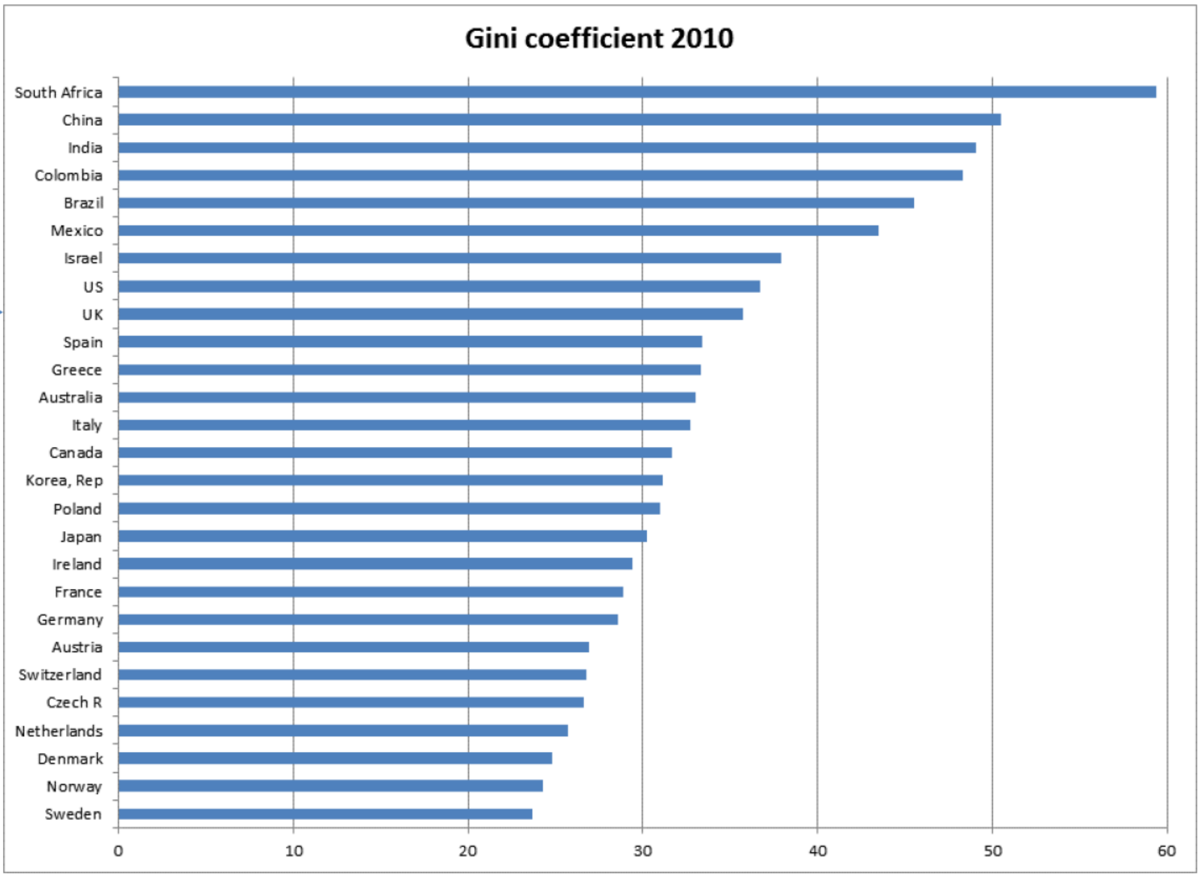
That said, although reactions to 'Capital' have been sharply divided, yet the sternest critics recognize that Piketty has a case to be answered, even if there is no 'iron law'. Piketty's hypotheses about 'perpetual inequality' may create theoretical unease, but the policy implications are stubborn. Perceptions about inequality and the widespread global debate are realities that require serious attention today.

As a general observation, there is no basis for assuming that the future of the global economic system is somehow threatened or assured by deterministic historic processes, but neither are there any cogent reasons for adopting an opposite hypothesis. The future of the world economy should not be viewed as prearranged, but as partly contingent and partly open, and progressively shaped by voluntarily driven human action exercising socio-economic options.

Piketty's conceptual framework also still needs to be tested against the circumstances and policies of particular countries. From a policy viewpoint, much of what is outlined in his substantial volume is often suggestive, rather than conclusive. What about SA?

4. What about South Africa?

Using his conceptual framework, can SA avoid Piketty's 'dystopian vision', given its huge historical inequalities in income and wealth? Can these extremes of wealth and poverty continue to co-exist? Is there a way out?



Source: Atkinson (2015). Inequality: What can be done?

INEQUALITY OF LABOR INCOME

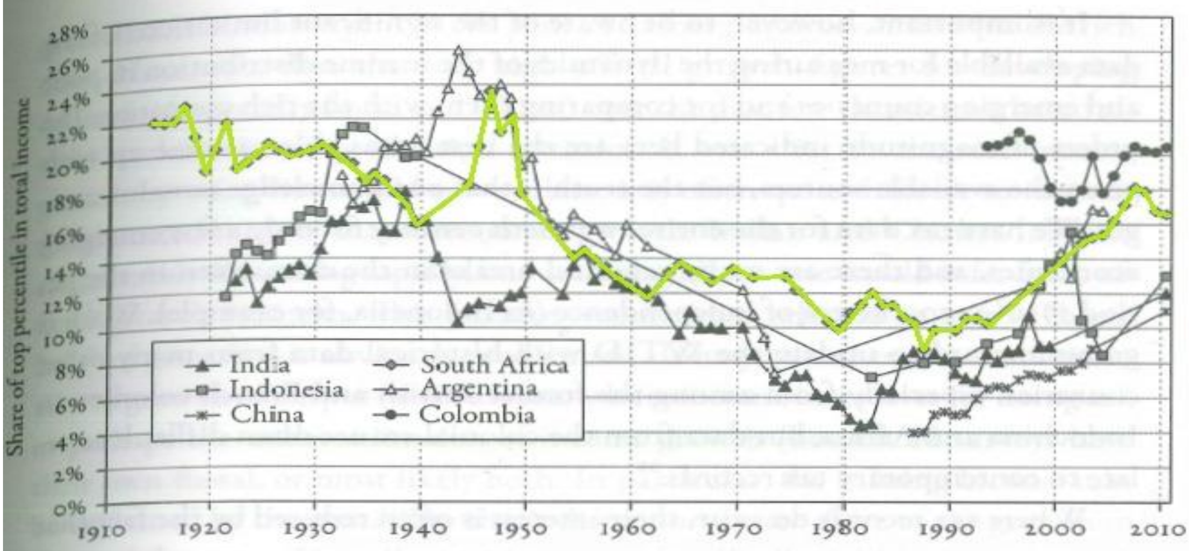


FIGURE 9.9. Income inequality in emerging countries, 1910–2010
Measured by the top percentile income share, income inequality rose in emerging countries since the 1980s, but ranks below the US level in 2000–2010.
Sources and series: see piketty.pse.ens.fr/capital21c.

In this regard it might be noted in passing how the issue of inequality of wealth and income in SA understandably persists, even after most other inequalities have been formally levelled in the post-apartheid period. Universal suffrage has conferred political equality. The much-praised constitution and other legislation have ostensibly brought about nominal equality in recent years. But whereas before inequality of wealth and income was hidden, so to speak, behind the other greater inequalities and enormous iniquities of apartheid, it is now in the foreground and draws the maximum attention through the language of wealth inequality and 'economic transformation'.

That said, in the first paragraph of Chapter One of 'Capital' Piketty refers to the Marikana tragedy in August 2012, when thirty four miners were killed by the police in a labour clash, as a classic example 'at the heart of distributional conflict', that is, the question of what share of output should go to wages and what share to profits? Fundamental tensions of this kind will clearly continue and may worsen, depending to a large degree on the outcome of ideas and policies that prevail on inequality. This is where the debate both globally and domestically is now located.

We need nevertheless to bear in mind that Piketty's research is focused mainly on inequality in certain developed or mature economies, rather than on emerging markets, which he says have the potential to achieve much higher 'catch up' growth, and which *can* adapt their institutions to ameliorate inequality, compared to advanced economies. What if we concentrate on (g) instead?

In the words of Piketty:

‘The value of return on capital can fall below the growth rate...from a strictly logical point of view, it is perfectly possible to imagine a society in which the growth rate is greater than the return on capital, even in the absence of state intervention...if, moreover, productivity growth in this society is rapidly catching up with more technologically advanced countries, the growth rate may well be distinctly higher than the rate of return on capital’ (Piketty pp. 355 and 358).

What if we now look through the opposite end of the telescope? Is this a persuasive conceptual ‘bridge’ to examining prospects for the SA economy? We recognise that it is only developing countries like SA that have the economic potential to 'catch up' with developed economies, and that can grow at 4%, 5% or 6% p.a or more, of which there are several recent examples. This kind of inclusive growth *could* push the growth rate above the private return to capital. This allows economic development to successfully address poverty and become a more equalizing process over time, usually over many years and supported by *appropriate* interventions.

5. Enter the National Development Plan?

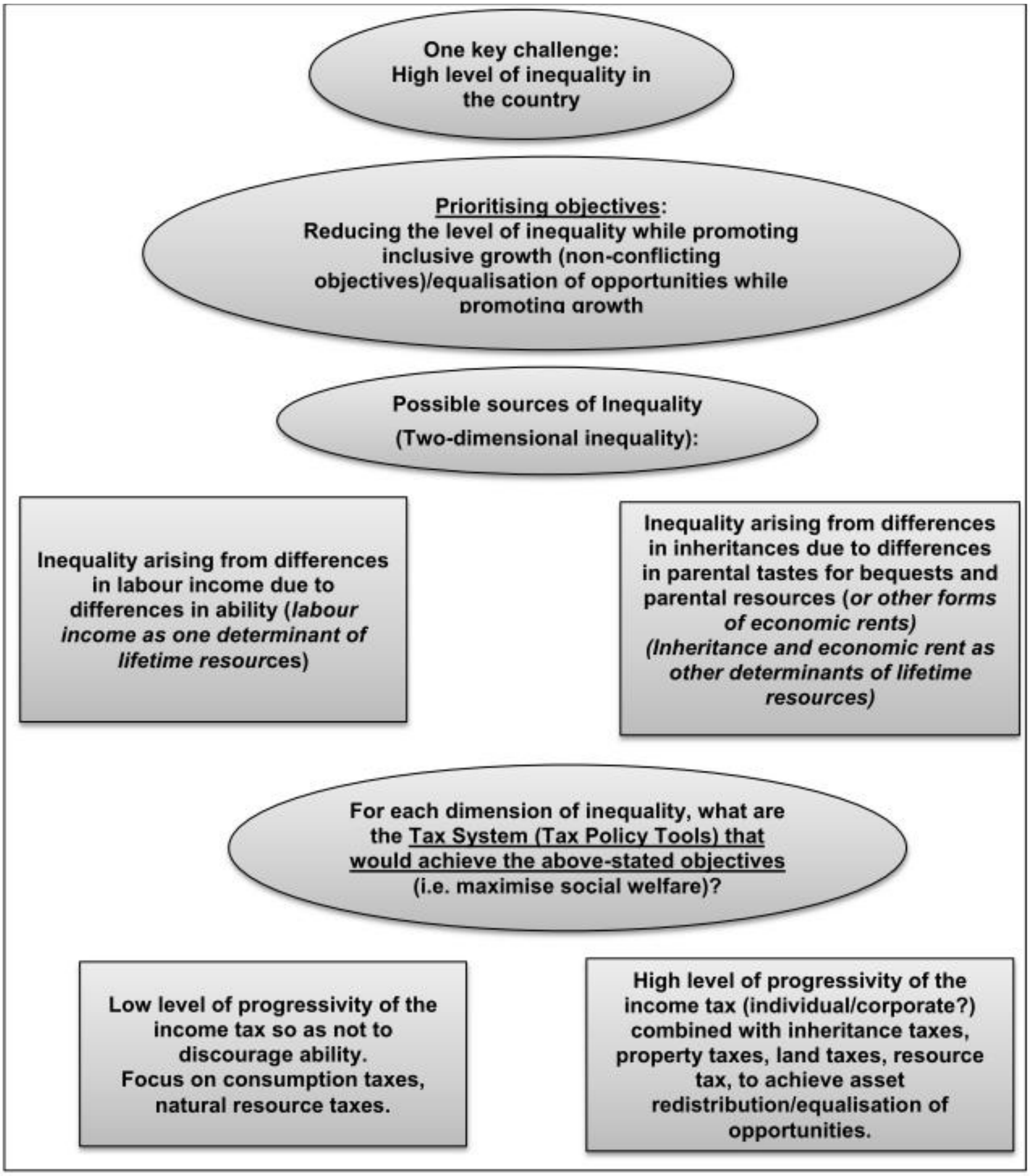
Piketty's model seems to offer SA (and other emerging economies) a higher job-rich growth option in which to embed remedies around inequality, *provided* there is broad acceptance of the primacy of inclusive growth in the hierarchy of national objectives. Given his overall conceptual framework, the extent to which several of Piketty's pointers for reducing inequality thus seem to align with SA's recent National Development Plan (NDP) is striking.

These include:

- the historical dynamics of wealth distribution outlined in Piketty enable us to gain a better perspective about inequality, both today and how it developed in the past (a template which is largely replicated in the historical background created by the National Planning Commission for the NDP framework in SA)
- when economic growth is high and when real wages rise, it is easier for the younger generation to accumulate wealth and 'level the playing field' with their elders (which is in line with the thrust of the NDP)
- it is abject poverty and 'relative deprivation' in the midst of 'plenty' that promotes social tensions and economic distortions, and which lowers standards of morality as well as productivity (which the NDP wants to ameliorate by 2030)
- economic growth alone is incapable of satisfying 'a more just social order' without creating specific institutions for the purpose and not relying solely on market forces or technological progress, but to fix 'mixed economies' and make them work better (which is consistent with the holistic NDP approach)
- the need to constantly interrogate the *efficiency of the public sector* to deliver better economic and social services (creating a 'capable state' to improve delivery is basic to the NDP's diagnostics and prescriptions)
- the focus on increases at both the top and bottom end of income distribution has implications for another highly contested area of public policy, namely, *labour market flexibility* (which resonates with the NDP emphasis on 'a more responsive' labour market)
- in the long run the best way to reduce inequalities with respect to labour, as well as to increase labour productivity, is *investment in education*. Labour market outcomes, especially returns to education and training, are essential. In the longer term education and technology are decisive determinants of wage levels and to promote skills 'diffusion' (all of which are cornerstones of the NDP)
- escalating executive remuneration in some countries rather than other suggests that institutional differences are decisive (which the NDP also captures for SA and which can be addressed through stricter corporate governance)

On tax issues the current work of the Davis Tax Committee (DTC), including on questions of wealth and inheritance taxes, is highly relevant. Piketty already resonates in the First Interim Report on Estate Duty by the DTC (January 2015) and in the document's outline of which tax policy tools might be considered in the SA context. Following Piketty and Saez (2012) the DTC report reproduces the following framework out of which it believes the tax options may evolve.

Some solutions to reduce the level of inequality while promoting inclusive growth



Piketty and Saez (2012)

It will be necessary to encourage serious engagement with the discussion document to ensure that SA does indeed design a tax policy aligned with the socio-economic goals of the NDP, as embodied in the terms of reference of the DTC. If the goal is to make (g) > (r), then tax policy should not hamper it. All that can be said at this stage is that, pending further outcomes, there are no simple technocratic solutions to the dilemmas of tax reform. What remains important is that, *if* properly and consistently implemented, the overall NDP economic roadmap offers SA an opportunity to 'catch up', in Piketty fashion, and to reduce historical imbalances by 2030.

6. Growth, Inequality and Efficiency

A recent World Bank Report (November 2014) nonetheless concludes that SA *is* managing a sizeable reduction in poverty and inequality through its fiscal instruments of tax and state spending, compared to certain other countries (Armenia, Brazil, Bolivia, Costa Rica, El Salvador, Ethiopia, Guatemala, Indonesia, Mexico, Peru, and Uruguay). However, inequality remains higher in SA than all of the other countries before they apply fiscal policies. It is also clear that addressing poverty and inequality consistently with *fiscal sustainability* in future will require higher and more intensive job-rich economic growth, and that there is minimum scope left for further redistribution via the Budget. Limits to government spending and redistribution now seem to be set by the rate of economic growth.

We know that, if economic growth can be successfully combined with dramatically increased employment, it helps to create a 'virtuous circle' by making people more productive and more employable, by becoming involved in the 'world of work'. This 'world of work' also has the potential to create an environment for technical entrepreneurship and innovation adapted to local conditions. To Piketty, even modest growth 'means that new functions are constantly being created and new skills are needed in each generation' (Piketty, p 85). More rapid and job-intensive growth must be SA's overarching strategy for dealing with widespread poverty, which is why it heads the NDP's list of priorities.

We must recall that there have been episodes in SA's recent economic history when unemployment fell significantly once growth exceeded 3%. Job creation on a large scale remains a basic generator of broad-based empowerment, as well as of inter-generational mobility. This is what *sustained* high economic growth makes possible. To translate this goal into reality requires at the very least an agreed growth plan which stretches well beyond short-term political and business cycles. The near-term outlook is largely determined by forces already in existence, and thus leaves much room for forecasting but relatively little room for policy.

In contrast, the long-run outlook puts less emphasis on forecasting and more stress on policy *implementation*. The attainment of the NDP goals therefore depends less on accurate forecasting than on visible and coherent day-by-day implementation. SA will not eliminate poverty and inequality by 2030 but it can give itself a better chance of ameliorating them by then.

Another important reason for decision-makers to address the inequality gap is *to get it out of the way*. For as long as income distribution in SA is seen as too far from what is 'socially acceptable', necessary policies for allocative efficiency are constantly suspect. Less inequality over time helps to reduce the occasions of conflict between allocative (productive) and distributive efficiency, or least makes them more manageable.

As Dani Rodrik has reminded us:

'It is good that economists no longer regard the equality-efficiency trade off as an iron law. We should not invert the error and conclude that greater equality and better economic performance always go together. After all, there is only one universal truth in economics. It depends' (Rodrik 2014).

There are still simply too many instances in SA where otherwise sensible economic measures are opposed or obstructed because they are perceived to have negative consequences for income distribution or 'economic transformation'. We need to move beyond this phase and achieve a much better balance. Clearly the choice of economic models remains of fundamental importance to deciding on the desirability of policy proposals. There remain tough decisions to be made in SA and, above all, for them to be successfully implemented.

Economic growth is not ‘a cure for all diseases, an end to all distress’. We recognize that growth creates winners and losers. 'Catch-up' is a potential; its successful exploitation depends on a variety of factors, at which a few economies succeed, and many countries fail. We know much depends on the composition of growth, such as the balance between consumption and investment, of which Piketty again reminds us.

In this process we nevertheless have the opportunity to match changes in equality levels with changes in economic growth. Rodrik (2014) emphasizes that the relationship between economic performance and equality is likely to be contingent, rather than fixed, depending on the deeper causes and several mediating factors.

7. Conclusion

Desirable socio-economic goals are unattainable where great and permanent inequalities exist; and are also unachievable where permanent equality might prevail. Where inequality and poverty are pervasive, few would contend that what pays best is what the community needs most. It is not necessary, though, to know what is best: it is sufficient to know what is *better*. Economic growth remains the most powerful weapon in the fight against poverty and inequality but, by itself, is insufficient. Policies that help the poor disproportionately, such as investment in rural infrastructure and health care, are also essential.

As the Piketty analysis underlines, growth can make other aims easier to achieve and soften conflict among them, including inequality. If we borrow from Piketty's conceptual framework, it means that fixing the root causes of inequality in SA requires repairing the root causes of low growth, and of wanting to make (g) > (r).

An important caveat: we should remember that equations themselves are in any case never the last word. In the world of symbols and equations it is true that everything is eventually either ‘this or that’. Piketty claims:

'The discipline of economics has yet to get over its childish passion for mathematics, at the expense of historical research and collaboration with the other social sciences.....this obsession with mathematics is an easy way of acquiring the appearance of scientificity without having to answer the far more complex questions posed by the world we live in' (Piketty, p 32).

Put differently, our conceptual framework creates the illusion that each dilemma has only two horns, but this occurs by assuming that experience is bound by the same rules as symbols. But we are dealing with a continuum, not a dichotomy. Reality is ambiguous. In the real world of growth and redistribution policies, more options are available.

In SA high inequality of income and wealth remains an uncomfortable and pressing reality, and therefore need to be addressed through a *strategy of institutional alternatives*, such as outlined for example in the NDP. Enhancing (g) brings into contention the institutional reforms needed to underpin it, including a well-functioning and supportive labour market.

Piketty's work does not overtake the excellent research already done on poverty and inequality in SA. Instead, Piketty reinforces and enriches the broad line of thinking on several aspects of current policy and opens up new avenues of research. What should be the appropriate tax policy in SA is one area of immediate interest. We also need to know more about how unequal wealth distribution in SA influences income inequalities, and what the implications may be for social cohesion. It is worth further exploring the alignments and divergences between the NDP and aspects of Piketty's study.

Finally, Piketty’s approach broadly supports the view that rapid economic growth has a recognised capacity to address widespread poverty and eventually, inequality. The lesson for SA is that the slower the economy grows, the longer these problems persist, and the more difficult they are to manage – especially when expectations escalate or have subsequently become severely disappointed. We must recognize that low growth and inequality are ultimately political choices, and SA can still choose otherwise

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