THE INEQUALITY PUZZLE

Thomas Piketty's tour de force analysis doesn't get everything right, but it's certainly made us ponder the right questions, according to LAWRENCE H.SUMMERS

Once in a while, a heavy academic tome dominates for a time the policy debate and, despite bristling with footnotes, shows up on the best-seller list.

Thomas Piketty's *Capital in the Twenty-First Century* is such a volume. Every pundit has expressed a view on his argument. Piketty's tome seems to be drawn on a dozen times for every time it is read.

This should not be surprising. At a moment when our politics seem to be defined by a surly middle class and the US President has made inequality his central economic issue, how could a book documenting the pervasive and increasing concentration of wealth and income among the top 1 per cent, 0.1 per cent and 0.01 per cent of households not attract great attention?

Especially when it goes on to propose easily understood laws of capitalism that suggest that the trend towards greater concentration is inherent in the market system and will persist in the absence of radical new tax policies.

Piketty's work richly deserves all the attention it is receiving. This is not to say, however, that all of its conclusions will stand up to scholarly criticism from his fellow economists in the short run or to the test of history in the long run.

Nor is it to suggest that his policy recommendations are either realistic or close to complete as a menu for addressing inequality.

Piketty's immense contribution

Let's start with its strengths. In many respects, *Capital in the Twenty-First Century* embodies the virtues that we all would like to see but find too infrequently in the work of academic economists.

It is deeply grounded in painstaking empirical research. And it finds that, even in terms of income ratios, the gaps that have opened up between, say, the top 0.1 per cent and the remainder of the top 10 per cent are far larger than those that have opened up between the top 10 per cent and average income earners.

Piketty provides an elegant framework for making sense of a complex reality. His theorising is bold and simple and hugely important if correct. Whether or not his idea is ultimately proven, Piketty makes a major contribution by putting forth a theory of natural economic evolution under capitalism.

His argument is that capital or wealth grows at the rate of return to capital, a rate that normally exceeds the economic growth rate. Thus, he argues, economies will tend to have ever-increasing ratios of wealth to income, barring huge disturbances such as wars and depressions.

Since wealth is highly concentrated, it follows that inequality will tend to increase without bound until a policy change is introduced or some kind of catastrophe interferes with wealth accumulation.

Piketty writes in the epic philosophical mode of Keynes, Marx, or Adam Smith rather than in the dry, technocratic prose of most contemporary academic economists.

Does Piketty help us understand inequality?

All this is more than enough to justify the rapturous reception accorded Piketty in many quarters.

However, I have serious reservations about Piketty's theorising as a guide to understanding the evolution of American inequality.

And, as even Piketty himself recognises, his policy recommendations are unworldly – which could stand in the way of more feasible steps that could make a material difference for the middle class.

Piketty's argument is straightforward, relying on a simple inequality in which the rate of return on capital exceeds the economic growth rate.

Slow growth is especially conducive to rising levels of wealth inequality, as is a high rate of return on capital that accelerates wealth accumulation.

According to Piketty, this is the normal state of capitalism. The middle of the twentieth century, a period of unprecedented equality, was also marked by wrenching changes associated with the Great Depression, World War II, and the rise of government, making the period from 1914 to 1970 highly atypical.

This rather fatalistic view can be challenged on two levels. It presumes, first, that the return to capital diminishes slowly, if at all, as wealth is accumulated and, second, that the returns to wealth are all re-invested.

Whatever may have been the case historically, neither of these premises is likely to be correct as a guide to thinking about the American economy today.

Economists universally believe in the law of diminishing returns. As capital accumulates, the incremental return on an additional unit of capital declines.

The crucial question relates to what is technically referred to as the elasticity of substitution.

With 1 per cent more capital and the same amount of everything else, does the return to a unit of capital

relative to a unit of labour decline by more or less than 1 per cent?

If, as Piketty assumes, it declines by less than 1 per cent, the share of income going to capital rises. If, on the other hand, it declines by more than 1 per cent, the share going to capital falls.

Economists have tried to estimate elasticities of substitution with many types of data, but there are statistical problems.

Piketty argues that the economic literature supports his assumption that returns diminish slowly and so capital's share rises with capital accumulation.

But I think he misreads the literature by conflating gross and net returns to capital. It is plausible that, as the capital stock grows, the increment to output produced declines slowly, but there can be no question that depreciation increases proportionally.

And it is the return on capital net of depreciation that is relevant. I know of no study suggesting that measuring output in net terms, the elasticity of substitution is greater than one, and I know of quite a few suggesting the contrary.

There are other fragmentary bits of evidence supporting this conclusion that come from looking at particular types of capital.

Consider the case of land. In countries where land is scarce, such as the United Kingdom, land rents represent a larger share of income than in countries such as the United States or Canada, where it is abundant.

Or consider the case of housing. Economists are quite confident that the demand for housing is inelastic, so that as more housing is created, prices fall more than proportionally – a proposition painfully illustrated in 2007 and 2008.

Does not the rising share of profits in national income prove Piketty's argument?

This is only so if one assumes that the only factors at work are the ones he emphasises.

Rather than attributing the rising share of profits to the inexorable process of wealth accumulation, most economists would attribute both the wealth accumulation and rising inequality to the working out of various forces associated with globalisation and technological change.

For example, mechanisation of what was previously manual work quite obviously will raise the share of income that comes in the form of profits: so does the greater ability to draw on low-cost foreign labour.

Editor's note:
imagine that the only capital in an economy was a road network owned by a very rich person. Adding more roads to the network will reduce the rate of return (diminishing returns) but Piketty argues that this will be outweighed by the extra total return the owner will get because there are more roads. His percentage rate of return per mile of road falls, but there are more miles. However, Summers is arguing that we also have to take into account the fact that the road network will depreciate and that, if we do, the evidence suggests that the total return to the road owner will fall.

Do capitalists simply accumulate?

There is also the question of whether the returns to wealth are largely reinvested. I am much less sure than Piketty.

At the simplest level, consider a family with current income of 100 and wealth of 100 as opposed to a family with current income of 100 and wealth of 500. One would expect the former family to have a considerably higher savings ratio.

In other words, there is a self-correcting tendency in that wealth will, in the long run, tend to be consumed, at least to some extent.

A brief look at the *Forbes* 400 list provides only limited support for Piketty's ideas that fortunes are patiently accumulated through reinvestment.

When *Forbes* compared its list of the wealthiest Americans in 1982 and 2012, it found that fewer than one tenth of the 1982 list were still on the list in 2012, despite the fact that a significant majority of members of the 1982 list would have qualified for the 2012 list if they had accumulated wealth at a real rate of return of even 4 per cent a year. They did not, given pressures to spend, donate, or mis-invest their wealth.

In a similar vein, the data also indicate, contra Piketty, that the share of the *Forbes* 400 who inherited their wealth is in sharp decline.

Why has inequality risen?

But if it is not at all clear that there is any kind of iron law of capitalism that leads to rising wealth and income inequality, the question of how to account for rising inequality remains.

In particular, why has the labour income of the top 1 per cent risen so sharply relative to the income of everyone else? No one really knows.

Amongst other things, the rise of incomes of the top 1 per cent reflects the extraordinary levels of compensation in the financial sector.

While anyone looking at the substantial resources invested in trading faster by nanoseconds has to worry about the over-financialisation of the economy, much of the income earned in finance does reflect some form of pay for performance; investment managers are, for example, compensated with a share of the returns they generate.

And there is the basic truth that technology and globalisation give greater scope to those with extraordinary entrepreneurial ability, luck or managerial skill.

Think about the contrast between George Eastman, who pioneered fundamental innovations in photography, and Steve Jobs.

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Jobs had an immediate global market, and the immediate capacity to implement his innovations at very low cost, so he was able to capture a far larger share of their value than Eastman.

Correspondingly, while Eastman's innovations and their dissemination through the Eastman Kodak Co. provided a foundation for a prosperous middle class in Rochester for generations, no comparable impact has been created by Jobs's innovations.

Where does this leave policy?

Piketty argues for an internationally enforced progressive wealth tax, where the rate of tax rises with the level of wealth.

This idea has many problems, starting with the fact that it is unimaginable that it will be implemented any time soon. Even with political will, there are many problems of enforcement.

How does one value a closely held business? Will its owners be able to generate the liquidity necessary to pay the tax? Won't each jurisdiction have a tendency to undervalue assets within it as a way of attracting investment? Will a wealth tax encourage unseemly consumption by the wealthy?

Success in combating inequality will require addressing the myriad devices that enable those with great wealth to avoid paying income and capital taxes.

Beyond taxation, however, there is, one would hope, more than Piketty acknowledges that can be done.

Examples include more vigorous enforcement of anti-monopoly laws; reductions in excessive protection for intellectual property in cases where incentive effects are small and monopoly rents are high; greater encouragement of profit-sharing schemes that give workers a stake in wealth accumulation; increased investment of government pension resources in riskier high-return assets; strengthening of collective bargaining arrangements; and improvements in corporate governance.

Probably the two most important steps that public policy can take with respect to wealth inequality are the elimination of implicit and explicit subsidies to financial activity and an easing of land-use restrictions that cause the real estate of the rich in major metropolitan areas to keep rising in value.

Hanging over this subject is a last issue. Why is inequality so great a concern? Is it because of the adverse consequences of great fortunes or because of the hope that middle-class incomes could grow again?

If, as I believe, envy is a much less important reason for concern than lost opportunity, emphasis should shift to policies that promote bottom-up growth.

At a moment when secular stagnation is a real risk, such policies may include substantially increased public investment and better training for young people and retraining for displaced workers, as well as measures to reduce barriers to private investment in spheres such as energy production, where substantial job creation is possible.

Books that represent the last word on a topic are important. Books that represent one of the first words are even more important.

By focusing attention on what has happened to a fortunate few among us, and by opening up for debate issues around the long-run functioning of our market system, *Capital in the Twenty-First Century* has made a profoundly important contribution.

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