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A great fresco on political economy and the world economy: Book review of Thomas Piketty, *Capital in the Twenty-First Century*[1]

Vittorio Valli

Piketty's book is an important book, not only for its huge success and the lively and engaging style of its author, but for its powerful and controversial contents. It is no wonder that it has raised the interest of other famous economists such as Krugman, Stiglitz and Milanovic[2], but also the attention of the media and the general public.

The book begins with the statement of the goal of putting distribution again at the centre of the economic agenda. This is followed by a brief, but well written, introduction on classical authors such as Malthus, Ricardo and Marx, and also more modern classics such as Simon Kuznets, as well as the author's critique of Kuznets's famous income distribution curve.

The first part of the book presents the main concepts used in Piketty's analysis. There are the definitions of income, product and capital. The latter is defined in a very broad sense, comprising both real and financial capital, and it is actually more akin to the concept of wealth than to the concept of capital used in standard macro-economic theory. National capital is a stock value, and it is the sum of private and public capital or of domestic and net external capital.

Another fundamental concept is, for Piketty, the capital/income ratio, that he calls β. The author shows that this ratio has been historically rather high (about 6-7) in the United Kingdom, France, and Germany during the 1870-1910 period. The ratio has declined to 2-3 in 1950 and then recovered to 4-6 in 2010. A beautiful chart shows for these three countries a sort of U shaped curve. In the United States, which was a much younger country than the European powers in the 19th Century, this level was a somewhat lower than in Europe. There the capital income ratio rose from 4 in 1870 to 5 in the great depression, then it went down to 3.8 in 1950 and finally rose up to 4.3 in 2010.

At this point Piketty introduces his first fundamental law: $\alpha = r \times \beta$, where α is the share of income that goes to capital, r is the rate of return on capital and β is, as before, the capital/income ratio. It must be pointed out that rather than a real economic law, this is an accounting equality, as the author himself admits.

Piketty then introduces his second fundamental law: $\beta = s/g$, where s is the saving rate and g is the rate of growth of the economy.

It should be noticed that this law is not particularly new. It is simply another way of stating the main Harrod- Domar result, $g = s/v$. Harrod's v is basically the β of Piketty, though Piketty uses a wider concept of capital than Harrod. Piketty

[1] Belknap Press/Harvard University Press, 2014, 685 pp., $39.95, translated from the French edition *Le capital au xxi siècle*, Editions du Seuil, 2013.

[2] See Krugman (2014), Milanovic (2014). For the comments on the media, see also, for example, Flanders (2014). See also a video of Piketty, Durlauf, Krugman and Stiglitz (2014).

acknowledges this fact in chapter 6, where he discusses also Domar's and Solow's contributions.

Finally, Piketty introduces his fundamental divergence factor: $r>g$. When for a long period of time the rate of return on capital r is higher than the rate of growth of the economy, inequalities in income and wealth tend to increase progressively.

Drastically simplifying the analysis, Piketty's model may be summarized thus:[3] If we assume $r > g$ for a long period of time, then by definition α (share of income going to capital) increases. That, combined with a rise of the capital/income ratio β, will continue to raise α, especially if the capital owners, becoming richer, will save and re-invest an increasingly larger share of their income than before. This will determine a rate of growth of capital exceeding the rate of growth of the economy, a further increase of β, that will raise α, and so on. There will, therefore, be a sort of virtuous circle for the wealthy and a vicious one for the poor, and inequalities will increase.

However, much depends on the basic assumption $r > g$, that has in Piketty only an empirical basis, not in a solid theoretical explanation. In fact, in chapter 10, Piketty concedes that the divergence law $r>g$ is more an historical reality than a logical necessity.

Piketty's empirical evidence is illustrated in an important graph, on p. 356 in the English edition, that shows how, except for a large part of the 20th Century and especially the golden age of 1945 to 1973, the percentage rate of return on capital (tax deducted) in the world has been higher than the rate of growth of the economy. In Piketty's view, the golden age had been an exception, not the norm. It was a very special period of high growth, mainly due, according to the author, to the consequences of the catching up of Europe and Japan after the great destructions of the two world wars, the extraordinary reduction of capital/income ratio and the consolidation of a progressive tax system.

However, in the last three to four decades there has been in several countries a return to high capital/income ratios, a high share of capital income on total income and a trend toward reduced capital taxes. There has thus been a return to "patrimonial capitalism" as it had been during the "Belle Epoque", though with some important differences.

While at that time the very rich were mainly great land-owners, heirs of great fortunes, or rich merchants or industrialists, at present several of them are mainly wage earners, extracting "super-salaries" and bonuses from large non-financial or financial corporations. This is true especially in the United States, but it is increasingly true also in the United Kingdom and other European countries, where wage disparities are soaring. This trend is only partly explained in Piketty's analysis, as he probably underestimates the great impact of globalization on wage disparities. Economic globalization tends to concentrate the apical functions of great corporations in the centre of the multinationals and fragment the production process in many countries. This increases the profits of multinationals and the possibility for top managers to obtain high compensations and generous bonuses, while rank-and-file workers are subject to the competition of immigrant workers and of the employees of foreign plants of their corporation. Moreover, financial globalization and financial innovation have powerfully contributed to increase the range of investment highly profitable financial assets and high-growth emerging countries. Thus globalization contributes both to an increase in wage differentials and to a gradual reduction in the meaningfulness of the comparison

[3] See Milanovic (2014), p. 522.

between *r* and *g* in any single country. This is particularly true for the very rich people who, as the author has correctly claimed, have recourse to sophisticated financial consultants and select the most lucrative investment all over the world.

Piketty concentrates much of his analysis on the share of income and wealth accruing to the very rich, the top 1 per cent of the population, on the basis of long-term tax records carefully examined by him and other well known economists like Saez and Atkinson.[4] Their studies have brought a welcome addition to the more aseptic studies of international organizations, which are generally based upon Gini indexes, deciles and national surveys.

In part 3 of the book, Piketty tries to delineate a response in terms of economic policy to the dangerous trend of a greater concentration of income and wealth in very few hands, in the top 1% of population.

Progressive taxes on wealth may contribute to arrest, or at least contain, this phenomenon. Piketty, for example, proposes an annual wealth tax of 0.1-0.5% for wealth under 1 million euros, 1% for wealth between 1 and 5 millions, 2% for wealth of 5-10 millions, and 2-5% for higher levels of wealth.

However, the author is realistic. He is conscious of the fact that the super-rich might succeed in capturing politics and tax policy through monetary contributions to parties and to influential politicians, and through the control of top multinationals, major financial institutions and media. The future may be doomed.

There are two minor weaknesses in Piketty's analysis. The predominant use of fiscal data for the measure of inequalities, although very useful and indispensable for very long-term analyses, has many limits (e.g., problems of tax evasion, etc.) and should be accompanied, whenever possible, with inequality-data based on national surveys. Moreover, the future economic trends will be more and more influenced by emerging countries, such as China, India and Brazil, on which the analysis of the book is limited, partly because of the great difficulties to obtain reliable data on private wealth in these countries.

Piketty's book is like a fascinating fresco, full of colours, personages and landscapes. It is a very attractive mixture of history, literature, economics and other social sciences, and it is based on a wealth of accurate empirical studies on income and wealth.

Though its theoretical foundations are rather slim, its empirical bases are very solid and founded on almost two decades of painstaking statistical and analytical work on inequality. The final message is clear and convincing. Growing and excessive economic inequalities in income, and especially in wealth, are undermining current and future economic growth and social cohesion in most countries.

[4] See, for example, Piketty (2003), Atkinson and Piketty (2010), Piketty and Saez (2003) and (2006), World Top Incomes Database (2013).

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