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Working Paper No. 18, Thomas Piketty on Capital and Inequality

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on
Capital and Inequality

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Abstract: This inquiry seeks to establish that, in his *Capital in the Twenty-First Century*, Thomas Piketty advances ideas concerning the origins and implication of economic inequality. Piketty commences his inquiry by considering and detailing wage differences amongst distinct classes of society. This mechanism for the distribution of income is compared across selected nations, and the differing tendencies over time are examined in detail. Distinct from working wages, Piketty considers income effects associated with capital ownership. Adding to this, Piketty shows that effects of inheritance need be considered as capital is passed to successive generations, thereby allowing the accruing of monetary gains to beneficiaries wholly independent of their labor inputs.

***Journal of Economic Literature* Classification Codes**: D63, P10, Y30

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This inquiry seeks to establish that in his *Capital in the Twenty-First Century* (1914), Thomas Piketty advances ideas concerning economic inequality. In his exploration of historical tendencies related to inequality, salaries of selected groups are revealed and their income shares juxtaposed to total national incomes. Correspondingly, wealth allocations to middle class and poor citizens are tracked for comparison. These tendencies are considered for multiple nations and over spans of decades and – in cases – over centuries.

In addition, Piketty's data sources serve to shed light on the importance of accumulated capital. From his research we learn that capital assets permit compounding growth and thereby allow owners to escape the forms of labor that most citizens are obliged to perform. Through this process, capital becomes apportioned from the productive members of society and bestowed upon non-contributors. Labor and capital incomes are statistically juxtaposed and compared in aggregate. Piketty also brings into account information regarding inheritances that allow for the perpetuation of inequalities associated with earlier differences in incomes accruing to labor and capital.

Inequality and Historical Evolution

What Piketty offers is lengthy and detailed account of how in the western world the distribution of wealth has taken place over a two hundred-year time span. In a section titled "The Structure of Inequality", Piketty (2014, 235-467) offers numerous historical measurements. This particular section exceeds two hundred pages and focuses upon the timeframe stretching from 1810 to 2010. This period starts with the expansion of industrialization and culminates in an era of a profoundly deep and encuring recession. Even closer focus is paid to the recent hundred years between 1910 and 2010. The latter interval benefits from plentiful income data summoned via tax records. Also, the last century includes analysis of inequality in the face of two world wars, an enduring depression, recessions, and phases of of hyperinflation. Piketty provides close scrutiny to several measurements of American and European wealth inequality. The chronological investigation is ripe with graphs and exhaustive explanations.

The section spanning two centuries of wealth inequality begins with an introductory chapter found in the seventh in the book. Piketty (2014, 237) terms this opener "Inequality and Concentration: Preliminary Bearings". He provides thoughtful reference to an 1835 novel titled *Père Goriot*. We are forced to consider the tremendous fiscal success of certain capitalists that are apportioned immense flows of wealth, but offer disproportionately minor contributions to society.

Chapter Seven eventually assumes statistical undertones. Piketty (2014, 247) offers tables quantifying income distributions respective to time and location. Table 7.1 concentrates on labor income, entirely separate from wealth made through capital gains, rents or dividends. It is immediately apparent that Scandinavian society in the 1970s and 1980s offered capitalism with a relatively egalitarian income distribution: the upper ten percent of income earners received twenty percent of labor income, while the bottom half of earners made thirty-five percent of labor income. While this is far from an equal or socialist distribution, it is nonetheless a mild form of capitalism. Conversely, the United States in 2010 revealed a more uneven spread: the upper ten percent of income earners received thirty-five percent of labor income. Additionally, the bottom half of American workers were paid twenty-five percent of wages.

Comparing Scandinavian income earners in the 1970s and 1980s with American income earners from 2010 reveals stark differences. Piketty (2014, 247) presents the telling data to support this. The upper decile of modern Americans were apportioned one and three-fourths the share of wages that affluent Scandinavians were previously apportioned. In simpler terms, upper class Americans from the Great Recession received almost twice the portion of wages compared to upper class Scandinavians from yesteryear. Similarly, the poor Americans of 2010 were paid about seventy percent of the wage share that their Scandinavian counterparts received decades ago. This is staggering when considering the immense GDP advantages of modern America. We are left speculating that contemporary Americans are surely not thirty percent less productive than Scandinavians from 1975. Useful context is given by the conversion of income data to a comprehensive percentage. Piketty's information demonstrates the significant factors of time and place when analyzing wealth inequality.

Chapter Nine: "Inequality of Labor Income" offers important details about the last century of wage inequality. Piketty (304-335) provides approximately thirty pages of graphs and text largely focused on the portion of wages allocated to the richest income earners. His point of concentration is Europe and America between 1910 and 2010. Despite a handful of global downturns and two world wars, the twentieth century witnessed tremendous growth in global trade, technology, and economic output. However, graphical presentations reveal the rebound of a dominant top ten percent. Meanwhile, anemic wage growth defines middle and lower class workers of the western world. The cyclical nature of inequality is shown, and Piketty provides exhaustive historical interpretations.

Capital in the Twenty-First Century details the effects of World War II on income distribution in America. Piketty (2014, 298) mentions the National War Labor Board, an American executive agency tasked with approving any raises between 1941 and 1945. This authority usually only allowed raises for low wage positions, and Figure 8.7 (2014, 299) shows that the top decile of American wage earners sacrificed a sizeable share of their salaries during the same years. American tax policy in the 1940s claimed massive portions of supersalary incomes. However, conditions changed dramatically after 1980.

Data about the minimum wage indicates income conditions for the lowest (legally) paid workers. Piketty (2014, 309) presents the impressive differences between French and American wage floors. While bottom class French workers saw consistent income improvements from 1968 to 2012, the US minimum wage decreased relative to inflation during the same period (especially after 1980). Piketty (2014, 316) correlates these periods with differing levels of opulence for the richest earners. Figure 9.2 (2014, 316) reveals high income earners pocketing a skyrocketing portion of American wages after 1980. The subsequent graph shows the opposite in France, Germany, Sweden and Japan; the share of top percentiles in total income barely changed from 1980 to 2010. Thus far, the influence of neoliberal policy for top earners (and what is leftover for the citizens below them) seems to be a largely American phenomenon.

Capital Income versus Labor Income

One economic factor may deserve even greater attention than wage inequality: inequality from capital. Rents from real estate, appreciation of land, capital gains from stock, corporate dividends, and interest from lending activity all comprise capitalism's tremendous windfalls to its beneficiaries. Returns to capital enable the owner to generate income without working. Large stockpiles of capital allow the most elite to avoid labor altogether. The returns from such investments typically outpace inflation, allowing the holder to consume a continually growing share of the world's wealth. The mathematical advantage of compounding value is formidable. Owners of large capital reserves often benefit from these processes while the workers beneath receive wage adjustments less than inflation. In *Capital in the Twenty-First Century* (2014), Thomas Piketty devotes painstaking detail to reveal the significant flows of income distinct from labor.

Financial capital is spawned from a right of ownership, usually shown as equity shares in a business, the control of debt, or possession of real estate. Early in the text, classical views from David Ricardo and Karl Marx are referenced. Piketty (2014, 5) mentions that both theorists argued a dominant class would "inevitably claim a steadily increasing share of output and income." Piketty (2014, 5) distinguishes that Ricardo believed landowners would be responsible, while Marx concerned over industrial capitalists. In today's world of handsomely compensated chief executives and unprecedented real estate valuations, both viewpoints are poignant. Piketty (2014, 113-234) dedicates a section of his text to highlighting capital assets and income streams. The section is titled "The Dynamics of the Capital/Income Ratio". All sources of income are separated between capital and labor. The former is indicative of ownership income, the latter is associated with genuine work.

Within "The Dynamics of the Capital/Income Ratio", Piketty provides historical context for the purchasing power of capital. The most simplistic valuation allows measurement of hoarded resources compared to current income levels. The resultant number is the capital/income ratio. A capital/income ratio of four would indicate that all of a nation's pooled assets are valued at four times the current summation of incomes. Crucially, some citizens may own fifty times the average national income, while other citizens exist in a position of net debt. Piketty (2014, 116) first offers a graph indicating historical capital valuations in Britain. The capital/income ratio was approximately seven in 1700, and underwent severe drops amidst the early twentieth century, reaching as low as two. It has since rebounded to approximately five. Piketty (2014, 117) offers a similar trend for France. These graphs indicate the severe shocks of the Great Depression and World Wars hampered the purchasing power of stored reserves. Additionally, Piketty addresses important questions about beneficiaries from public debt. Piketty (2014, 132) refers to French bondholders who lived off the interest from government war bonds in the nineteenth century. Bondholders from this era benefited from extremely low inflation and government payouts nearing three percent. However, a series of partial payment defaults and mounting inflation eventually turned the tables. While capital incomes don't require additional labor input, they require choice of allocation and have demonstrated historical volatility.

Contemporary information about capital incomes is also offered by Thomas Piketty. Chapter Six exclusively concerns "The Capital-Labor Split in the Twenty-First Century". Unlike the crude valuation of capital, this analysis provides a weighing mechanism against recent data from labor income. Piketty (2014, 222) reveals a staggering graph in Figure 6.5: capital's income as a percentage of national income has steadily increased since 1975. Eight nations are examined with matching trends. Piketty (2014, 222) mentions "Capital income absorbs between 15 percent and 25 percent of national income in rich countries in 1970, and between 25 percent and 30 percent in 2000-2010." This information is consequential; current owners of capital receive nearly a third of American income without working. The distribution of these capital incomes also begs interest. The income from capital is not spread evenly among all citizens.

The balance of juxtaposing workers against owners is worthy of study. While slavery is outlawed in most modern societies, many humans work in subsistence conditions while top-tier managers and absentee owners enjoy splendour. The harsh contrasts between poverty and extravagance cause wonder if these differences are truly attributable to varying exertions of work ethic. Even middle class wage stagnation can lead to inquiry. Does an executive receiving fifteen-million per annum offer 300 times the intelligence or toil of an average employee earning fifty-thousand? Piketty's exposé of differing income streams allows this examination. An honest analysis reveals that compounding returns from capital permit some to rest while others work. American culture supposedly cherishes potential from any hardworking starter. Class mobility is required for a meritocracy, or the game is rigged. The natural question is begged: how is the almighty capital apportioned? Surely the privilege to siphon income while avoiding labor should not be bestowed by mere circumstance of birth.

Transfer of Wealth Through Inheritance

The deployment of financial capital with compounding returns provides a clear advantage to the asset holder. A trivial game of Monopoly mandates that each player begin with an equivalent amount of currency and no other assets. The ensuing accumulation of wealth is entirely subject to chance and ingenuity. Any deviation in starting currency allotments would be quite worthy of argument by game participants. No such law governs the real world. In fact, certain people begin asset accumulation paths with unusually large sums of starting capital. These hoards of capital are often attained by no effort from the bequest recipient. Some are allowed the advantage of compounding returns by circumstance of birth, while others face the unlikely task of catch-up via labor. This hereditary elite is contrary to the ideals of meritocracy. In *Capital in the Twenty-First Century* (2014), Thomas Piketty provides revealing data and speculation about these inheritance trends, primarily in France.

Nowadays, inheritance of capital is less pronounced than it was during the nineteenth century. However, the relative portion of bequeathed gifts has increased dramatically since 1980. In Chapter Eleven, “Merit and Inheritance in the Long Run”, Piketty (2014, 380) shows these allocations in France. Figure 11.1 (2014, 380) shows the annual value of inheritance expressed as a percentage of France’s national income. This measurement shows a realistic gauge for these transfers by identifying inheritance capital’s portion. The chart details such a trend between 1820 and 2010. The valuation is respective to quantities that include labor income. It is revealed that in 1820, French inheritance and gifts accounted for about twenty percent of national income. Relative growth of these estates resulted in a value of around twenty-four percent by 1880. In other words, this inegalitarian era apportioned almost one quarter of money flows via pure inheritance mechanisms. Given previous findings about wealth concentrations from that era, these financial flows benefitted a few rentiers handsomely. Piketty (2014, 380) also explains the collapse of these estates after 1914. He correlates the shifts with World War I and perceptions about capitalism ending. Likewise, World War II had a similar devastation on the power of inherited capital. An era of merit charmed 1950-1960;

Piketty (2014, 381) states “bequests and gifts accounted for just a few points of national income, so it was reasonable to think that inheritances had virtually disappeared and that capital, though less important overall than in the past, was now wealth that an individual accumulated by effort and saving during his or her lifetime.” This era rapidly vanished between 1980 and 2010, with French inheritors almost tripling their influence. While American capital faced increased authority under Reagan, French inherited estates also expanded.

The value of inheritance capital can be assessed in another manner. Piketty (2014, 391) also examines the wealth of the dead compared to the living. Data from 1820 to 2010 shows this peculiar comparison. The ratio has usually been over 100 percent; assets left behind are grand compared to the assets an average worker holds. Piketty (2014, 391) explains the “Modigliani triangle,” a theory taught to economics students that states workers amass wealth to spend in retirement. In other words, a society where everyone works for themselves (and receives only what they earned) would show retirees dying with relatively little left behind. In fact, reality is quite opposite from this idea. The average estate at death exceeds the wealth hoards from an average living worker. The implication is that inherited wealth plays a more powerful role than wealth acquired via toil and saving. The dead wield a tremendous influence on society’s inequities. Table 11.1 (2014, 394) shows that as the holder ages, capital can grow at a rate faster than depletion. This reinforces earlier arguments about the influence of early advantages. Recall these are averages, and many retirees have insufficient capital to finance their own existence. Nonetheless, the perpetual family fortunes of upper deciles do reduce future necessity of work for some. Asset distributions are not primarily determined by merit.

Data about the role of inherited capital provides valuable insight to structural shifts of inequality. Thomas Piketty presents research and thoughtful analysis of historical inheritance patterns. Capital carries tremendous power in magnifying the wage inequalities of our century; unusually high salaries permit the recipient to invest large portions and reap future compounding returns. The supersalaries of current American executives will likely offer advantages to a pampered bloodline. Among these possible benefits are elite educations, the privilege to evade labor, compounding returns from capital, and influential congressional lobbying to immunize such advantages from attack. Current tax code offers few safeguards to prevent the amassing of such hereditary fortunes at the expense of workers. Piketty's 2014 book provides insightful and revealing ideas about such dilemmas of inequality.

Conclusion

This inquiry has sought to establish that in his book *Capital in the Twenty-First Century*, Thomas Piketty advances ideas concerning economic inequality.

Middle and lower class workers in America have witnessed the dwindling power of their wages in dissonance with inflation. This has occurred despite technological and education improvements bestowing the overall economy with higher output per worker. Since 1980, these advancements have primarily benefited the highest paid class. The top decile has also seen their capital comprise a growing share of national incomes after the two world wars - at the cost of laborers. These astounding advantages for the rich may continue if inheritance tax laws remain permissive of large endowments. Shockingly, reductions of the estate tax have proliferated through western nations. Nepotism can continues in lieu of merit, and the multiplicative effects of capital can accelerate wealth disparities. Piketty's publication has awoken the public with common knowledge on a previously ignored front. Alarming disparities demand a constructive solution from society. Intelligent conversation exists regarding a public benefit fund, allowing a portion of capital ownership by all citizens and bestowing universal dividends.

Bibliography

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