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Garnaut versus Piketty inequality in the coming century

If something cannot go on for ever, states Herbert Stein's law,[1] it will stop. In itself this is not very informative, but it opens the way to three interesting questions: (1) why can't it go on for ever?; (2) where and when will it stop?; and (3) why? Generations of economists have applied this line of inquiry to the accumulation of wealth (or its narrower version, capital) and to its close relative, the share of national income going to the holders of wealth. Their answers have varied widely.

Adam Smith in 1776 saw no reason why accumulation could not go on for ever. David Ricardo in 1814 thought that the growing income claim of unproductive rentiers would squeeze capitalists' returns against the immovable barrier of the subsistence wage, and eventually bring capitalist growth to a halt, in the process putting a limit on wealth. Marx in the 1850s thought that accumulation carried the seeds of its own destruction: a rising capital–output ratio would drive down the profit rate and trigger intensified exploitation of labour, leading to class conflict that would destroy capitalism itself. Keynes in the 1930s predicted 'euthanasia of the rentier' as an increasing stock of wealth drove down the rate of return. In Solow's 1956 growth model, the combination of diminishing returns and the physical fact of depreciation led to the prediction that the capital–output ratio would stabilise at an equilibrium level, with total capital growing only at the economy's rate of growth. Thomas Piketty takes this one step further by arguing that the wealth/income ratio has a long-run equilibrium at a value of around five or six, while the long-run return on wealth tends to stabilise at a value above the long-run growth rate of the economy, producing a society with dramatic and sustained long-run inequality of both wealth and income. All (except the pre-Ricardian Smith) agree that in a closed-economy setting, 'too much capital', as Piketty puts it, 'kills the return on capital' (Piketty, 2014, p.215).

In a key passage in the middle of his Holmes Lecture Ross Garnaut singles out the relationship between capital accumulation and income inequality as the 'question that will be most important in shaping global development in the 21st century'. He argues, echoing Keynes in the final chapter of *The General Theory* (Keynes, 1936) that in a world of abundant capital and output the long-run rate of return on capital must fall to negligibly low levels. Garnaut interprets Keynes' position as follows:

> abundance will cause the rate of return on capital to fall to low levels. People who have a lot of capital will not have enormous incomes simply as a result of that ownership. This world will see 'the euthanasia of the rentier'. For those who are interested in access to the important things of life, there will be an abundance, so that questions of inequality will not matter very much.

What, then, should we make of the recent increase in inequality? Garnaut interprets it as merely a short-run hiccup due to falling global interest rates. Piketty views it as empirical evidence in favour of his thesis that global inequality is on track to return to 18th-century levels. (Garnaut also, in the passage quoted above, proposes that inequality matters only in relation to 'the important things of life', by which he

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seems to mean essentials as distinct from luxuries and positional goods. Here I think he strains credibility, both because the possession of positional goods is a crucial part of the inequality story, and because his assumption that abundance must eventually trickle down to everyone requires an unduly big leap of faith.) While I agree with Garnaut about the importance of the issue, I think he is too quick to suggest that 'Keynes is right and Piketty wrong'. In this comment I shall try to explore this in a bit more depth.

First off, one has to bear in mind the difference between wealth and capital, a distinction that Piketty has unhelpfully obscured by using the term 'capital' to refer to the broader category of 'wealth'. Economic growth theories that predict a steady (or possibly stationary) state for the economy, with a stable equilibrium capital/output ratio, generally conceive of capital as an input to the productive process, without which growth itself cannot happen. Therefore, a fall in the rate of return on capital as it accumulates translates into a fall in the incentive to invest, which in turn slows accumulation itself.

There are three familiar limitations to this story. The first lies in the concept of capital itself, the subject of the 'Cambridge debate' in the 1960s, which I will not pursue here. The second is the brute fact of depreciation, which means that in the steady state of, for example, a Solow economy the rate of return on investment at the margin cannot fall below the rate required to incentivise replacement investment to maintain the capital stock. This in turn puts a limit on the extent to which diminishing returns can drive down the rate of return on productive capital.[2]

The third is the fact that (as Keynes, Garnaut and Piketty all acknowledge) savings do not all automatically become embodied in new productive capital. There are a wide range of forms in which wealth can be accumulated, of which productive capital is only one. Landed property and buildings are the most obvious,[3] and confer upon their owners the power to collect rent, at a rate of return which tends to rise rather than fall as productive capital accumulates relative to land (Ricardo's point).

Financial assets such as government bonds are a different form of wealth with different dynamics: excess current savings drive down the rate of interest at which new loans can be made, but in the process drive up the value of existing bonds issued in the past at higher rates. Garnaut attributes the recent rise in inequality to this mechanism: 'much of the increase in wealth and income at the top of the distribution in this century … reflects once-and-for-all increases in asset values associated … with the decline in interest rates themselves'. Hence, as existing loans expire and are rolled over at lower interest rates, even a very large portfolio of bonds will yield only a meagre income, which leads Garnaut to predict that the current level of inequality will prove unsustainable in the face of abundance of capital and a low rate of interest.

Garnaut may eventually turn out to have been right, but I would nevertheless emphasise three factors that add weight to Piketty's side of the debate.

First, Keynes' original discussion of euthanasia of the rentier (Keynes, 1936, pp.375-7) was far from all-encompassing. The rentier whose demise he foreshadowed was the 'functionless investor' who secures rents on financial assets only so long as capital remains scarce, so that the rate of interest has to be at a level sufficient to attract funds to net new investment. Keynes expected his 'euthanasia of the cumulative oppressive power of the capitalist to exploit the scarcity value of capital' (p.376) to flow from, and depend directly upon, capital abundance, which if necessary was to be secured by direct state investment sufficient to ensure capital abundance at full employment. Keynes acknowledged, though, that rent on land is different, because 'there are intrinsic reasons for the scarcity of land' which do not disappear simply because of capital abundance. Thus, only one category of rentiers suffered euthanasia in his account. For the others, Keynes was happy to see large income and inheritance taxes imposed (p.377). Euthanasia by capital abundance, in short, was a selective process which would leave much wealth untouched in the absence of high tax rates.

Second, 'land' is shorthand for a large range of bottleneck resources that are inherently in limited supply and hence command sustainable rents in a market economy. Social(ist) ownership of these resources could prevent them from becoming the basis for gross inequality of wealth and income, but under private ownership there is no obvious endogenous tendency for their value to decline, nor for their ownership to become dispersed, either of which might bring inequality down. Hence, those individuals who secure ownership at the bottlenecks can continue to ride the escalator of rising rent and 'capital gains'.[4] Just as Keynes set aside this aspect of capital abundance, so does Garnaut gloss over the future of land-based rentals and the associated inequalities.

Third, Piketty's position has a long-run historical grounding which puts a considerable onus on Garnaut to demonstrate why 'this time is different' from the two millennia up to 1900. In Piketty's theory of history, the 20th century appears as a one-off deviation from the long-run human propensity to create and sustain highly unequal societies. The deviation, in his account, was driven by an eruption of new social and political forces that broke the power

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of the old ruling elites and established a high-tax, high-wage welfare state and mixed economy. Those forces faded in the late 20th century in the face of the resurgence of financial power and neo-liberal ideology, following which the age-old disequalising forces are back and will consolidate unless democratic forces revive. Hence Piketty thinks we must 'bet everything on democracy' (Piketty, 2014, p.573); that is, on a new wave of deliberate political intervention to block the disequalising tendency of the market economy.

Garnaut, following Keynes, views the 20th century not as a short-run historical aberration but as the launching pad for a long-run growth path leading to global abundance and greater equality. In this view, the history of inequality prior to 1900 is an irrelevant distraction, and the recent sharp increase in inequality is a temporary aberration, from which the economies of the developed countries are expected to recover of their own accord as the rest of the global community completes its transitional phase of rapid growth and accumulation.

I hope, for obvious reasons, that Garnaut is right, but I did not find his argument against Piketty persuasive. The jury remains out on how the long-run accumulation story will play, and I am uneasy about bringing the authority of Keynes to bear in support of the proposition that the currently low interest rates prevailing in the global economy will necessarily prevail into the long run – that is, for the coming century – and translate into a new period of devaluation of wealth. Keynes' rentiers certainly had a thin time of it for half a century after *The General Theory* in the face of strongly interventionist policy in the advanced economies, but the story of recent decades has been one of resurrection of the rentier and consolidation of their well-funded stranglehold over policy. *Laissez-faire,* this suggests, is not likely to prove the best response to inequality.

This brings me to the question of what, if anything, Garnaut thinks we ought to do about inequality. His optimism about the long-run equalising tendency of the market economy, and consequent rejection of Piketty's extrapolation of the recent trend towards inequality, seems to point to a relaxed *laissez-faire* stance. Yet he argues for 'effective government … to run tax and expenditure policies that constrain inequality in income distribution within limits that are consistent with political support for growth-sustaining policy', seems to support Piketty's proposal for a global wealth tax, and worries about the power of vested interests. As did Keynes eight decades ago, Garnaut seems to be holding state intervention in reserve, to wield the axe if and when the free market fails to deliver on his long-run vision of euthanasia of the rentier in a world of general abundance. I was left wondering how long he would be willing to wait to see whether the falling interest rate (see his Figure 2), on which he lays such stress, can indeed be sufficient to reverse the recent rise in inequality.

1 http://en.wikipedia.org/wiki/Herbert_Stein.

2 Keynes makes this point clearly: 'it would not be difficult to increase the stock of capital up to a point where its marginal efficiency had fallen to a very low figure. This would not mean that the use of capital instruments would cost almost nothing, but only that the return on them would have to cover little more than their exhaustion by wastage and obsolescence together with some margin to cover risk and the exercise of skill and judgment' (Keynes, 1936, p.375).

3 The dominance of housing as a component of total present-day wealth is conspicuous in Piketty's statistics and in the corresponding New Zealand data (see Bertram, 2015) and fits uneasily with his mathematical model of equilibrium capital accumulation: see Rognlie, 2015 and Malpass, 2015.

4 'Capital' here obviously carries the meaning wealth.

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