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Debraj Ray's Critique of Piketty's $r > g$ thesis

From Debraj Ray, *Nit-Piketty: A comment on Thomas Piketty's Capital in the Twenty First Century*, May 23, 2014. Full text available at *www.econ.nyu.edu/user/debraj/Papers/Piketty.pdf*

(pp.2-3)

[...] At the time of that writing, and coming into the end of a long stock market boom in the United States, the fact of rising inequality was already widely visible, and several papers were being written on the subject. Two of the main contenders were labor-displacing technological change (computers, for instance) and the rise of globalization, which kept domestic wages down while allowing profits to grow [...]

What Piketty brings to this particular table are the following points:

1. Inequality has been rising, and to see it well, one should study "top incomes,": those of the top 1% or even, in a variant which we might call SuperOccupy, the top 0.1% or 0.01%. This is an extremely important observation. There are lots of people in the top 1% (more in India, for instance, than in a good-sized European country), and they cast a long and enviable shadow [...]

2. Piketty's second point is that the rise in inequality is driven, by and large, by the progressive domination of *capital* income. Piketty presents different pieces of evidence to suggest that "capital" is making a comeback, and yes, it is important to put capital in quotes because he does lump together a variety of forms of capital in that term: ranging from capital holdings that directly bear on production (such as stocks or direct investments) to those that might serve a more speculative purpose (such as real estate). On these matters the empirical story is far less firm, though Piketty doggedly sticks to Capital (oh, but the title at all costs!). For instance, Bonnet et al (2014) observe that once housing prices are removed from the Piketty compilation of capital, the phenomenon of rising share of capital income goes away [...]

There is also the not-so-small matter of the United States, an exception noted by Piketty. It is unclear that the story of rising inequality in the US is one of physical (or financial) capital coming to dominate. Rather, inequality in the United States appears to be propelled by incredibly high returns to human capital at the top of the wage spectrum. This points to a very different set of drivers, and also shows that the physical capital story is not pervasive.

(pp.4)

And so we come to Piketty's Third Fundamental Law, what he calls "the central contradiction of capitalism":

> *The rate of return on capital systematically exceeds the overall rate of growth of income:* $r > g$.

[...] Here is what Piketty concludes from this Law, as do several approving reviewers of his book: that because the rate of return on capital is higher than the rate of growth overall, the income of capital owners must come to dominate as a share of overall income. Once again, we are left with a slightly empty feeling [...]

The rate of return on capital tracks the *level* of capital income, and *not* its growth. If you have a million dollars in wealth, and the rate of return on capital is 5%, then your capital income is $50,000. Level, not growth. On the other hand, g tracks the *growth* of average income, not its level. For instance, if average income is $100,000 and the growth rate is 3%, then the increase in your income is $3000. Saying that $r > g$ implies that capital income will grow faster than labor income is a bit like comparing apples and oranges.

[...] [L]et us look at a situation in which the argument apparently holds. Suppose that capital holders save all their income. Then r not only tracks the level of capital income, it truly tracks the rate of growth of that income as well, and then it is indeed the case that capital income will come to dominate overall income, whenever $r > g$. But the source of that domination isn't $r > g$. It is the assumption that capital income owners save a higher fraction of their income!

Now, is there anything special about capital income that would make their owners save more of it? [...] [W]ell, possibly, because the owners of capital income also happen to be richer than average, and richer people can afford to (and do) save more than poorer people. But that has to do with the savings propensities of the rich, and not the form in which they save their income. A poor subsistence farmer with a small plot of land (surely capital too) would consume all the income from that capital asset. It may well be that the return on that land asset exceeds the overall rate of growth, but that farmer's capital income would not be growing at all.

[...] [Piketty's] argument does not pin down whether [...] inequality will manifest itself in the ultimate domination of capital income, as defined by Piketty. It might, if the rich choose to save their wealth—or transfer it over generations—in the form of dividend-paying capital assets. And they do, more often than not. But it won't, if the rich use skill acquisition as the vehicle for their intergenerational transfer. It would show up in human capital inequality instead. (And indeed, some version of this discussion appears to be true for the United States, a notable exception to the Piketty argument, though my argument shows that the exception isn't so exceptional after all.)