{ WEALTH DIVIDE }

JEREMY WARNER

Today's growth in inequality is hopefully just a temporary problem

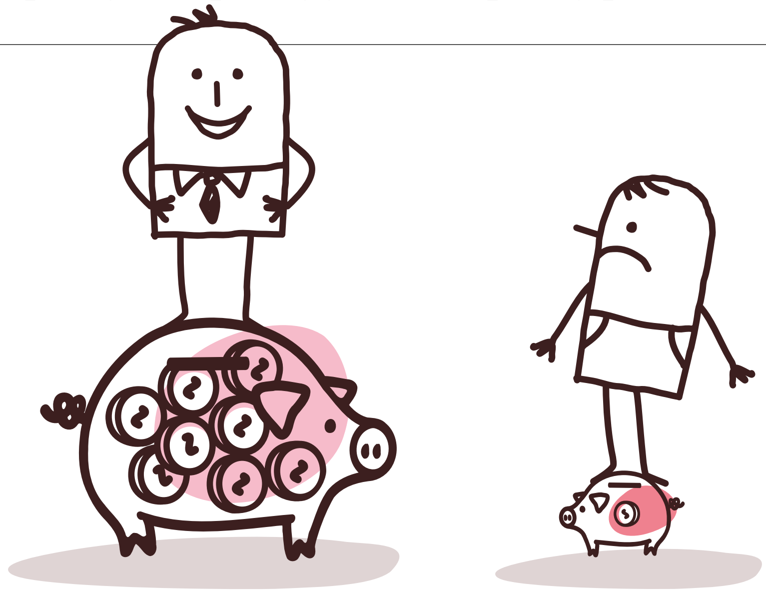
Inequality has always been a hot topic in economics, but rarely more so than today. Both the wealth and income divide in the industrialised world are approaching levels not seen since the late 19th century.

To generally rave reviews, the English translation of *Capital in the Twenty-First Century*, a mighty tome by the French economist Thomas Piketty, has just been added to the growing weight of inequality research and literature.

Piketty's big new insight is to demonstrate that from the early 1980s onwards, the rate of return on capital has been growing at a faster rate than wages and the economy as a whole. Those with existing pools of wealth are therefore getting ever richer, with the rest left behind. If current trends continue, Piketty argues, "the consequences for the long-term dynamics of wealth distribution are potentially terrifying".

Is he right about this? I'm sceptical both about the analysis and the proposed solutions, which Prof Piketty summarises thus:

"US inequality may now be so sharp, and the political process so tightly captured by top earners, that necessary reforms will not happen – much like in Europe before the First World War. But that should not stop us from aspiring to improve. The ideal solution would be a global progressive tax on individual net worth. Those who are just getting started would pay little, while those who have billions would pay a lot. This would keep inequality under control and make it easier to climb the ladder."



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First, let's deal with the supposed inevitability, if unchecked, of a growing wealth divide. This presupposes that returns to capital will remain permanently above the rate of GDP growth. In fact, such capital accumulation was not the case throughout much of the 20th century, when a growing proportion of both income and wealth went to the masses.

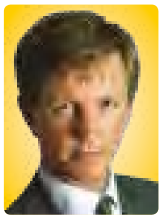
In Piketty's view, this was because of the wealth destruction and general social levelling of two world wars and the Great Depression. By the late 1970s, these effects had dissipated, leaving capitalism's assumed tendency towards 'rentier' behaviour free to reassert itself. No doubt there is something in this argument, but a better explanation is the one put forward in the 1950s by the American economist Simon Kuznets, which quite convincingly postulated that early-stage returns from any industrial revolution will go to capital, but that eventually the benefits flow through to consumers and households – the so-called 'inverted U-curve'.

Today, we are going through another great, productivity-enhancing revolution – characterised by the age of the computer and mass communications, and the advance of the smart machines. There is, then, every reason to suppose today's growth in inequality is a temporary problem, even if it may still have some way to go.

As for 'solutions', Piketty's proposed globally imposed wealth tax is a complete non-starter, both from a practical and a theoretical point of view. Even if an equitable way of assessing net worth could be found, the chances of securing the necessary international agreement for any such tax would be zero.

What's more, it wouldn't work. Set too low, and it would simply be paid out of the returns on capital and would therefore have no effect on the wealth divide. Set too high, and it would rapidly become wealth-destructive, forcing a fire sale of assets to pay the tax, and thereby causing a deflationary spiral in asset prices. No one would benefit from such a process.

Left unchecked, an increasing wealth gap will eventually become destabilising, both socially and economically. But wealth taxes aren't the way forward. Rather, solutions lie with supply side reform that substantially lifts productivity and once more enables growth to be higher than capital accumulation.



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