

Out With The Old: Kuznets Curve Refuted

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Summary: *The popular approach to studying the income inequality in developing economies has long been the Kuznet's Relation, which hypothesizes an inverted U-shaped curve. This article explores how this theory has been refuted by subsequent research, particularly by Thomas Piketty's. Piketty with the help of an impressive dataset, challenges the claim that developed economies succeed in abating inequality.*

Inequality - whether of income or wealth - is an infirmity, not endemic to just any particular economy. It is a gap that has widened more than it has closed. Capitalism for long was thought to be the panacea that would eventually bring those at the top, the middle and the bottom together. But it is Thomas Piketty's 700 page long rebuttal that has ushered a paradigm shift in our thinking.

Kuznet's Curve

Back in the old world, when Thomas Piketty had yet not become the 'rockstar economist' and when the global economy was still aggrandizing from the fruits of industrialization, Simon Kuznet proposed the hypothesis for the Kuznet's curve. In simple terms, the hypothesis states that as a country experiences economic growth, income inequality would first rise and after a certain point, it would start falling. Hence, the inverted 'U' shaped relation that the Kuznets curve reflects.

His assumptions were less purported by empirical data and more by speculations. He had focused mostly on the data from U.K and U.S.A, and his hypothesis was based on those trends. Initially, he had assumed a two-sector model economy, comprising the agrarian sector and the industrial sector. He had begun with the reasoning that before industrialization takes place an economy is predominantly agrarian, which is low in productivity. Everybody earns about the same income and are equally poor. Hence inequality is low. But as the country faces industrialization, there is a tendency

among farm workers to move towards the industrial sector, which is considered to be more productive and provides higher wages. So for example, when a factory is established in a village, farmers leave their jobs to work in the factory, where the average income is higher. So the inequality first increases, (because the factory workers are now earning more on an average than the farm workers), as the factory owners too experience increasing profits. Hence as the country's GDP rises, income inequality also rises. This continues till such a large exodus has taken place from the agrarian sector, that very few people are left behind. It then becomes more productive and the fewer workers left experience increase in their wages. This is the point in the Kuznets curve after which it begins its downward journey and inequality starts to converge to equality.

The curve has since been extensively debated upon. His theory, mostly based on precarious premises, has often been refuted, as an invalid extrapolation. For example the East Asian Miracle, which saw rapid economic growth in some East Asian countries, was not accompanied by any increase in income inequality but rather an absolute decrease in it.

Evidence: World Wars and beyond

Kuznets work, published in 1955, was based on Income Tax returns data from the U.S. which was available only after its introduction in 1913. In the data from 1913-48, Kuznet found that there was a sharp decline in income inequality in the US. This led Kuznet to conclude that the economy had now reached the downward sloping part of the curve where inequality falls. However, later theories debunk the claim; the sharp reduction in income inequality that we observe in almost all the rich countries between 1914 and 1945 was due above all to exogenous factors like the world wars and the violent economic and political shocks they entailed (especially for people with large fortunes) (Piketty 2014). In fact, it is claimed that Kuznet himself was aware of and had talked about the results being largely accidental at the American Economic Association.

Piketty has broadened the temporal and spatial limits

of Kuznets data on distribution of wealth and income spanning three centuries and over twenty countries called the World Top Incomes Database (WTID), which he says 'is the largest historical database available concerning the evolution of income inequality'.

He uses the data to show that income inequality in the US is back to the levels last seen before the Great Depression; the top decile claimed as much as 45–50 percent of national income in the 1910s–1920s before dropping to 30–35 percent by the end of the 1940s. We subsequently see a rapid rise in inequality, until by 2000 we have returned to a level of 45–50 percent share of national income by the top decile (Piketty 2014).

In European countries, inequality is not as extreme as in the pre-World War era but it is still extremely high. In the 18-19th century and until WW1, about 90% of aggregate wealth accrued to the top 10% wealth holders and about 60% of aggregate wealth accrued to the top 1% wealth-holders. Piketty calls this 'the classic patrimonial (wealth-based) society' where a minority lives off its wealth, while the rest of the population works. Now, the figures are about 60-70% for the top 10% and about 20-30% for the top 1%. The bottom 50% still owns almost nothing (<5%) but the middle 40% now owns 20-30% of the aggregate wealth and thus, suggesting the rise of a patrimonial middle class. (Piketty 2014)

Debunking the old theory: Piketty's Capital in the Twenty First Century

With this data, Thomas Piketty refutes Kuznets claim that developed economies are successful in abating inequality. Piketty says that as long as $r > g$ i.e. the rate of return on capital is greater than rate of growth, the wealth will get concentrated in the hands of those with capital. With this, it is not income inequality but wealth inequality that he has brought to the forefront. He also contends that deviations from equality can be attributed to disparity in skills, knowledge and productivity. Wealth, he asserts, has become more concentrated among the top 1%. The so-called rich evade income taxes by showing income as expense incurred, while their wealth remains untouched. The returns they receive from investments, such as in stock market or real estate, average at 5%, clearly more than

the GDP of most developed countries. He has shown how the top 1% rich almost control the entire stock market. According to him, the amassed wealth is passed on from generation to generation and thus there is little scope for equality without redistribution of this wealth. So capitalism itself creates such inequality.

In the past, the justification to capitalism was provided through the 'marginal productivity theory'. That is markets, through the laws of supply and demand, allocate the resources according to every individual's productivity. So those with higher incomes were more productive than those with lower income. But Piketty counters this theory by giving the example of the L'Oréal heiress who does not do a day's work but has amassed huge amount of wealth. Family dynasties and not talent find their place at the top of the pyramid. That is the rich earn more than the proportion of labour they put in. The brief period of fall in income inequality after the Second World War and the Great Depression, according to him, was an exception that is unlikely to repeat itself.

He asserts that the wealthy are growing wealthier and he even points the finger at the superrich managers who are being paid 200 times the income of an average employee. He doesn't believe that inequality will fall any time soon as wealth will grow at a rate higher than the growth rate of an economy and the rich cannot spend all that they have. That is 'capital reproduces faster than output is produced'.

Joseph E. Stiglitz in his book 'The Price Of Inequality,' supplements Piketty's findings. Stiglitz faults the political system, which he claims is completely in the hands of those at the top. The loudest clamour for lowering the regulatory bars have always come from the rich corporates, who were largely also responsible for the financial crisis. The reason the rich circumvent the taxes on their income so easily is because 'they design the rules of the game'. They model the political system to suit their needs. To quote Joseph E. Stiglitz 'The rich are not creating wealth; they're just shifting wealth around'.

Solutions for an equal society

Solution would be lowering 'r' i.e. the rate of return on capital enough so that 'g' i.e. economic growth overtakes it. For this, Piketty suggests a progressive

annual tax on capital. Capital as he defines it would be buildings, machines, patents, factories, stocks and bonds etc. The basic idea is to take away the capital of the rich veiled as tax. Now if such a tax were to be introduced it is quite possible that the rich would simply hide away their wealth abroad. It is for this very reason that he insists that the tax be 'global'. But such an ideal world of equal taxation is hard to imagine. Eminent economists have also refuted his solution of eradicating tax havens. The political system is ultimately in the hands of this top 1%. Also Piketty's solution does little to fix the system.

Criticism of the new theory:

The criticism of Piketty's work, like any other theory as ambitious as his, is loud and multi-hued. The critique ranges from the theoretical foundations of his work, his policy recommendations to the accuracy of the data and the analysis itself.

It is one of his major claims that has raised the most eyebrows. Piketty says that when $r > g$, inequality increases because capital income would grow faster than non-capital income. However, Piketty does not engage in hypothesis testing, statistical analysis of causation or even correlation. Even when there are arguments about inequality increasing *because* r exceed g , this is not supported by standard econometric or even correlation work, which in fact do not provide much evidence to support the claim (Dr. Acemoglu and Robinson). Joseph Stiglitz, in his new book *The Price of Inequality*, says that inequality is what causes low growth, instead of the other way round as Piketty claims.

To counter his argument about wealth accumulation being the major factor that results in inequality, it has been said that 'today's super-rich mostly come by their wealth through work, rather than via inheritance (The Economist 2014). 'In the Forbes 400 list of the wealthiest Americans, about half the people on the list are entrepreneurs whose companies did very well

(thanks to hard work as well as a lot of luck). Contrary to Piketty's rentier hypothesis, I don't see anyone on the list whose ancestors bought a great parcel of land in 1780 and have been accumulating family wealth by collecting rents ever since..that old money is long gone—through instability, inflation, taxes, philanthropy, and spending.' (Gates 2014)

Chris Giles, of The Financial Times, had raised serious concerns on the data and the analysis. He has pointed out some embarrassing mistakes in Piketty's data entry, but his other concerns the analysis have been dismissed for most part (Reed 2014)

Piketty's data and analysis while can be questioned; the fact that inequality is becoming a natural characteristic of every economy cannot be doubted. What's terrifying is the idea that for those at the bottom and the middle, there might not even be a ladder to climb up from. Piketty has definitely succeeded in refocusing the world's attention on the mess that remains untangled and there is, if at most a hope, that the problem now figured out, a solution will likely follow... and soon.

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