



BOOK REVIEW

THE ECONOMICS OF INEQUALITY

by Thomas Piketty, translated by Arthur Goldhammer, The Belknap Press of Harvard University Press, 2015, vii + 142, ISBN 978-0-674-50480-6

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The problems of income inequality today could not be more alarming, with the top rich 1% having more wealth compared to the rest of the world's population. At this rate, the 62 richest individuals – as opposed to 67 richest individuals in 2014 - owned wealth as much as the poorest 3.6 billion population combined; the bottom half of the world population (Hardoo, Ayele and Fuentes-Nieva, 2016). These figures shocked attendees at the World Economic Forum annual meeting in Davos. Thomas Piketty's "The Economics of Inequality" thus could not be published at a better time, when the infamous top 1% possessed an unprecedented amount of wealth and the scandal of huge sums of money being poured into politics to influence its policy design has been highly debated and gained popularity among the concerned societies; example can be seen in the huge support Senator Bernie Sanders received in challenging the establishment in the USA. *The Economics of Inequality* has actually been published earlier in France in 1997 and has been slightly updated since then. This is its first publication in English. Some of the issues highlighted in this book - pressure of demographics, skill-biased technological change and changes in public policy including taxation for political reason leading to very significant long term changes in inequality – have been discussed in more detail in Piketty's magnum opus in 2013, *Capital in the Twenty-First Century*. As such, *The Economics of Inequality* can be regarded as an introductory text book to his best-selling book *Capital in the Twenty-First Century*.

Thomas Piketty is a French economist and a professor at the Paris School of Economics whose specialization is income and wealth inequality. A research paper written by Piketty and Saez in 2001,

“Income inequality in the United States, 1913-1998” has caught much attention especially among those who thought that inequality merely exists because of the wage differential between skilled and non-skilled labor. It attracts both economists and political scientists to the relationship between the movements of the now infamous top 1% and political polarization.

A major point of the book can be found in the introductory chapter. It started with a discussion on two traditional political positions – the right-wing free-market and left-wing position – which often involved in inequality discourse. Each reflects a different system of redistribution; pure redistribution (transfers from high earners to low earner) and efficient redistribution (interventions in the process of human capital formation), respectively. These two positions dominate the discussion throughout the book. “The Economics of Inequality” discussed two different forms of inequality; capital-labor inequality and wage inequality. Wage inequality is actually a major factor contributing to income inequality, not capital income as many might have thought, though the latter is severely unequally distributed.

The right-wing free-market argued for minimum government intervention in the redistribution process through taxes and transfers; pure redistribution with fiscal redistribution. The market force and allocative role of price system should be allowed to operate freely as the market is already in a “Pareto-efficient” condition; the market will determine the distribution of income and standard of living. It is also believed that inequality is “efficient” and inevitable. The rise of wage inequality especially since 1970 is attributed to the movements of supply and demand of different levels of human capital especially during the deindustrialization process in the 1960s. The blame thus falls on the failure of the education system and rapid development of skill-biased technological change rather than human capital inequality itself. Thus pure redistribution – fiscal redistribution tools should prevail, only if elasticity of substitution between different levels of human capital is high.

The left-wing on the other hand argued that it is not enough to have a fair redistribution process by only relying on taxes and transfers to the poor. The government thus is allowed to intervene in the market price system and change the structure of market forces (market imperfection) which has been regarded as the cause of inequality. This is where the system of efficient redistribution through direct redistribution tools is needed to have a Pareto-efficient improvement in the market. Fiscal redistribution will not solve the structural cause of human capital inequality. The situations such as labor market

discrimination and huge monopsony power of employers required efficient redistribution tools such as affirmative action through quota provision and minimum wage legislation to restore market competitive wage, respectively. A more efficient resource allocation thus can be achieved while enabling more equitable wealth distribution.

The use of affirmative action to combat human capital inequality has proven to be effective in Malaysia. Malaysia adopted such a policy in 1971 through the second prong of the New Economic Policy (NEP) but at a larger scale; it not only covered the labor market but also the education sector in giving privilege to the Bumiputera – indigenous group – who are economically backward in Malaysia. The policy has brought success where a large segment of Bumiputera capitalist and middle class has been successfully created, though there are some criticisms such as the rise of favoritism and cronyism among the Bumiputera elites post-NEP (Embong, 2002; Kamal, Hwok-Aun and Abdul Khalid, 2014).

The elasticity of capital-labor substitution plays an important role in determining the effectiveness of the two redistribution tools; fiscal and direct redistribution, under two different redistribution systems, namely pure and efficient redistribution. If the capital-labor substitution is highly elastic, fiscal redistribution shall prevail, and vice versa. In taxing capital – Piketty suggested a flat tax on capital – to channel transfers to labor, elasticity of capital supply must be considered. If it is highly inelastic, fiscal redistribution is superior over direct redistribution. Nevertheless, one has to bear in mind that merely depending on the elasticity to decide which redistribution tools to be used will be the same as allowing for the allocative role of price system to operate freely in the market; which has always been accused of being imperfect. It is feared that elasticity then will be used to justify redistribution in the name of economic efficiency and not from the pure social justice point of view.

Piketty concluded that one has to realize that inequality issues are multifaceted. One cannot claim that all inequality happened because of inefficiency. It is the same way of denying the role of fiscal redistribution. It is also true that pure redistribution cannot eliminate all forms of inequality, but at least it will weaken inequalities especially in the standard of living. Using efficient redistribution also does not always solve all the problems of inequality. It is also essential to identify efficient redistribution wherever it could possibly exist. So we need to use either efficient or pure redistribution where necessary.

The shortcoming of this book is that the interpretation of wealth is rather narrow and does not take into account the unprecedentedly high property prices nowadays which play a significant role in a severely unequal distribution of income and wealth (Kanbur and Stiglitz, 2015). However, this book undoubtedly has indirectly confirmed the notion of equity and justice and how they are viewed in Islamic economics discussion on income distribution. Ahmad (1984) argued that the optimal level of distribution in Islamic economics should take into consideration two factors; equity and justice. Equity is needed to ensure that no significant part of society will be left out of the general socio-economic development. Justice on the other hand will ensure that all members of the society will be justly-rewarded according to their effort. Both equity and justice as described by Ahmad (1984) in Islamic economics can be found in this book, for example, when it comes to solving the labor discrimination problem in the labor market. The black workers having the same qualification as the white workers are not getting equal opportunities of getting hired; they need to have higher qualification in order to get employed. Thus it is clear that the effort being put by the former has not been equally paid and they have been the marginalized segments in the labor market. The efficient redistribution tool as explained earlier is needed to address this market inefficiency type of problem. The arguments made by Piketty on using various redistribution instruments by two different redistribution systems, though using old data, proved to be very useful in today's ever increasing debate on income inequality especially for policymakers where the decision-making process must not be caught between the two extremes of major views on redistribution. It is important to note that Piketty discussed not only the available policy options, but also the most viable options given certain circumstances of inequality. Such a diverse way of solving for capital-labor income inequality has shown that very careful analysis is needed before one can decide on implementing any redistribution instrument.

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