# Piketty and the middle income trap

**PUBLIC INTEREST**

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Thomas Piketty's seminal work "Capital in the 21st Century" empirically establishes a macroeconomic premise driving inequality: that the rate of return on capital (r) tends to be significantly higher than the rate of growth of income (g). When $r>g$, wealth accumulated in the past yields more income than that earned in the present, generating inequality. Redistributive fiscal policy corrects this by taxing the incomes and assets of those who earn incomes from r and providing subsidies and merit goods to those earning incomes from "g".

This relationship holds when labour and capital resources are more or less fully employed (the "steady state"). Only changes in productivity and technology can change the values of *r* and *g*.

That's the rich country inequality problem. But emerging and developing economies such as India are, by definition, not at steady state. They are "catching up" with developed economies, and as long as they are doing so, the opposite relation holds: $r<g$. In India, *r* is about 7.5 per cent (return on bank deposits), and *g is* 11.5 per cent (the nominal GDP growth rate). This is important for it means that growth can be financed by borrowing, with a surplus that will increase the current incomes of those who produce growth.

It is a matter of great concern if inequality rises when $r<g$. This is not so just for normative reasons; if a rising tide lifts all boats, then the prosperity of all will increase, and that is a good thing, even if some become more prosperous than others. However, the history of development tells us this is not automatically so. To see this, contrast Brazil with Japan. In Brazil, unlike Japan, a steady state has been reached but inequality keeps a large number of people in relative poverty and extreme vulnerability. Growth provides no panacea for this as r is now equal to, or greater than, *g*. This situation, called a middle income trap, occurs if inequality rises when $r<g$, something that simplistic linear projections of growth ignore.

When inequality is increasing in spite of $r<g$, it is important to understand whether, and to what extent, the process of growth itself is inherently unequalising. India is in a historically novel situation. The Japans of the world grew by exporting to richer countries. The incomes from such export-led growth stimulated domestic demand, which further increased g, and allowed these countries to complete their development transformation. However, the age of export-led growth is at an end. Changes in technology and patterns of production mean that for countries such as India, increases in output and income can only be complemented by external demand (exports); they cannot be the main driver. While exports are important to improve productivity, India's development transformation will depend largely on increased *domestic demand* for goods and services.

Whether the temporary $r<g$ dividend can be used to complete the development transformation and avoid a middle income trap, therefore, depends on what the pattern of domestic demand is that generates g in India. Over the long run, an economy which is producing the things that the bulk of its population wishes to (and can afford to) consume will see a more inclusive growth process than one which produces only things that a section of the rich consume. Market signals won't help here. If India produces stuff that the top 100 million consume, then that's a huge market which will satisfy the immediate growth impulse. But this music will stop as this demand plateaus. We will then be in a classic middle income trap where the rich are taxed to provide minimum services to the poor, who will be kept from extreme poverty and vulnerability by using such taxes to subsidise their existence — including through a universal basic income in perpetuity — with economic prosperity being a partial achievement, not a universal one. We will be Brazil. On the other hand, if India produces what all Indians want to consume efficiently, and at affordable prices, then inclusive growth will stave off the middle income trap. We will be Japan.

I think there are five things that all Indians want to consume at affordable prices. A square meal, basic clothing, a house for every family, affordable education, and affordable health care. As things stand, *none* of these five are the drivers of growth. They are invisible in the Sensex, and in the "leading indicators" used for growth forecasting. Aviation, automobiles, FMCG, housing for the better-off are the lodestars of that 100 million consumer world, and the drivers of our growth for the past 25 years. A classic setting for a future middle income trap.

The middle income trap will not be overcome through subsidy or redistribution, but through policies that promote affordable production that is able to meet the demand of 600 million Indians for these things through the market mechanism (and of the other 600 million through subsidy, which will decline as inclusive growth raises their purchasing power). This is not what our economy is delivering today, or will in the future, if business is to be as usual.

I have ideas, as I am sure others do, on how to tackle this challenge but we need to collectively first recognise that this is what Indian policymaking needs to focus on, before the Cinderella hour strikes, and the $r<g$ dividend vanishes.

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