7 Economies without Capital

If (as recent data seem to suggest) wealth has outgrown capital, capital’s composition has shifted from equity towards debt, and public debt has expanded to rescue and replace the private sector’s, what are the social and economic implications? Why does the power of capitalists, to concentrate national income and shape public policy, seem to grow as the presence of capital declines? The answers seem to lie in the imbalance between saving and investment flows that were examined in the first two chapters, but move in a different direction when confronted by the capital shortage suggested by the third.

Capital and its (re)valuation again

Capital is an accumulation of physical and human resources that can generate output and income over time. It is the result of extended transactions, involving present activity leading to future income generation which is financed by money obtained in advance of that income being maintained. If investment is structured (and succeeds) so that streams of debt repayment run roughly parallel to streams of income receipt through time, it need not involve any sales arising earlier or later than expenditure of the resultant income. So it need not represent any withdrawal from the circular flow. If investment is not structured this way, and instead involves expenditure ahead of any production and income receipt, it causes a net injection to the circular flow, as in the simple Keynesian model.

For savers who buy corporate equity, there is in principle no difference between income (if the company pays dividends) and capital
gain (if the company reinvests distributable profit and its shares rise in value). If the intention is to keep saving, such distributions will be channelled into new share or bond purchases: the same amount will be added to savings, and the only question is whether the company or the individual shareholder controls the reinvestment. Taxation on dividends and lower tax rates for capital gains than for income can create a bigger difference and push preferences towards reinvestment. Companies have increasingly sought to overcome this by buying back shares instead of paying dividends. But if individuals prefer to receive the income (giving them a choice of where to reinvest) rather than restricting reinvestment to this one company, their pre-tax preference will be for distribution, and the higher tax on distributions may merely be restoring savers’ indifference.

However, from a whole-economy viewpoint the receipt of income may have very different implications from the receipt of a capital gain. The marginal propensity to consume from capital gains has generally been found to be positive, but smaller than that from earned income, and highly variable across countries (e.g. Bhatia & Mitchell 2010, Bover 2006, Dvornak & Koehler 2007). When capital gains are on housing, their macrolevel effect on consumption may be partly offset by a fall in tenants’ consumption propensity as they anticipate higher rents (Guiso et al. 2005). Low (and occasionally zero) propensities to spend more when wealth increases can easily be related to ‘permanent income’ theory, if asset values are viewed as volatile so that gains are liable to reversal. But it is possible that the propensity to spend is greater when asset appreciation brings the opportunity for equity withdrawal, because in a credit-constrained world the rarity of such chances to borrow means that holders of wealth (especially houses) seize them when they can.

Whether a low propensity to consume from capital gains means a muted effect on aggregate demand depends on how large the gains are, and how widespread. Thurow (1975) long ago drew attention to the disproportionate role of asset revaluation in creating personal fortunes. Overnight changes in asset values can add more to individual and household wealth than a lifetime spent chasing promotion and saving out of work income. The goal of ‘asset-based welfare’ is to equip everyone with a portfolio that can raise overall income faster than work income, and keep it flowing if work ceases. But this presumes that assets are widely held and that their appreciation