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## A Fable on Wealth and Capital

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**Copenhagen  
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HANDELSHØJSKOLEN

# **Department of Economics**

Copenhagen Business School

**Working paper 16-2005**

**A FABLE ON WEALTH AND CAPITAL**

**Niels Blomgren-Hansen**

# A Fable on Wealth and Capital

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On a small sunny island there once lived a community of coconut growers. The islanders had the same simple life as their forefathers and were happy about it. When they were young they climbed the trees and picked coconuts. They consumed half of the nuts they picked and stored the other half for consumption when they grew old and could no longer climb the trees.

The coconuts they stored for later consumption gradually decayed. In fact, half rotted away, so the amount of coconuts for consumption as pensioners was only half of the amount of coconuts they had stored as young. But they didn't complain. They used to tell their children that God had created the island, themselves and the coconut trees. Even though they didn't like to see people grow old and die and the coconuts rot they stuck to the belief that what God had created was perfect.

The island was headed by a wise man called a hogon. The hogon settled conflicts among the villagers, gave good advice, taught the children what was right and what was wrong, and talked to God on behalf of ordinary people who felt a bit uneasy about how to address God. Because of that he was considered a holy man and treated with much respect. He didn't have to work; to show their respect the villagers brought him the coconuts he needed. He lived in a hut somewhat larger than the ordinary villagers. Nobody but the hogon was allowed to enter the hut, because it was considered a holy place.

One day when the hogon sat outside his house thinking about God and the villagers' good life it struck him that the young people stored fresh coconuts and the old people ate old half-rotten coconuts. The decaying of the stored coconuts was clearly a loss to society. If somehow that loss could be avoided everybody would be better off.

God liked that the hogon cared for ordinary people and said to him in a dream, "Go and tell the young people to bring the coconuts to your hut instead of storing them in their own huts. For each coconut you receive you shall give them an IOU and tell the young men that for each IOU they return as old they will get a fresh coconut".

So he did, and the young people found it was a bright idea and looked forward to doubling their standard of living as old compared to what used to be

the case. They didn't quite understand how the hogon could keep their coconuts fresh, but the hogon was a holy man and they didn't doubt his word.

When the time came he delivered as he had promised. Every day a flow of young people delivered fresh coconuts to the hogon's hut and got IOUs in return, and an equally large flow of old people came to the hut and got a fresh coconut in return for each one of the IOUs they had collected as young.

So life continued for many generations. But as time passed peoples belief in God and the hogon's holiness weakened and one day a young man said, "How can I be sure that the hogon can and will fulfil my IOUs when I grow old? I will go and see if he really has a pile of fresh coconuts in his hut". And so he did, forced his way into the hogon's hut and found that there wasn't a single coconut.

He got angry and called all villagers - young and old - to a general meeting. Here he told them that the hogon had cheated them, that their claims were just pieces of paper not backed by a single coconut, and that, consequently, they could never be fulfilled. The fraud had made the village poorer. In the good old days they owned a large stock of coconuts. Now they had nothing but a pile of paper notes.

The hogon was called to the meeting and asked for an explanation. He had none. When he took over the post as hogon there were no coconuts in the hut and, to his knowledge there had not been for generations. What actually happened to the originally collected coconuts he couldn't tell. Some villagers suggested that the old hogon might have eaten the coconuts himself, other that the nuts had simply rotted away, and those villagers who respected the office of the hogon the most thought that the old hogon was a good man and had given the coconuts to the poor.

The angry young man requested that the fraud should be stopped, the hogon driven out of the village and the villagers return to individual coconut storing and self-support.

But an old soberminded man stepped in and said, "Listen, let us cool down. Sure, it was also a shock to me to hear that our IOUs have no backing and haven't had for generations. But, nevertheless, the practice has worked fine. To give it up will be a disaster. The old people will have nothing to live from and the young will find their standard of living as old halved. So let us continue saving for our retirement by selling coconuts to the hogon for IOUs as we use to do. After all the hogon has always fulfilled the IOUs we have returned, so why shouldn't he do so in the future?"

The villagers were convinced and returned to their daily work.

After the meeting the hogon asked the angry young man to come to his hut for a private talk. "Your are a smart young man and I understand your logic when you say that we have all become poorer", he said. "The villagers own IOUs but these IOUs correspond exactly to my debt or rather to the debt of my office, so on balance we own nothing. But, nevertheless, in my mind it makes little sense to say that we have all become poorer, when in fact we all feel wealthier and have a better life. I think that the appropriate notion of wealth should reflect our standard of living and include not just the value of physical

coconuts but also the value of virtual coconuts - i.e. the IOUs - that the villagers have collected. Or - to put it differently - when accounting the village's wealth we should not subtract the debt of my office".

"No", answered the young angry man, "that would be wrong. One day - maybe in a distant future - the debt must be repaid, and as you own nothing, you or your successor will have to tax the villagers. So, even though the villagers don't feel so, your debt is in fact the villagers' debt. They might feel wealthier, but that is just an illusion. Illusions - virtual coconuts - can never count for real wealth."

The hogon smiled. "Listen, the debt collected by the hogons in the past corresponds to one half of one generations total production. Assume that we decide that it should be repaid in this period. How could that be achieved? We might renege on the outstanding debt. That would rob the old generation their means of living. We might instead tax the young generation, i.e. force them to continue to deliver coconuts to my hut without getting anything in return. As the young will have to care for their retirement by stockpiling coconuts and half of the stock will rot, the young generation's consumption in their entire lifetime will be just  $3/8$  of what it is today and  $1/2$  lower than the level of consumption that prevailed before the old hogon started issuing IOUs long time ago. No matter what, it would be a disaster for the villagers and do good to nobody."

The young man nodded; the hogon clearly had a point. "But", the hogon continued, "if we must conclude that it is a bad idea to repay the debt now, why should it be a good idea to repay the debt in the future? If future generations are as wise as we are they will just go on rolling over the debt as we have done and never repay. Is a debt that must never be repaid really a debt? In my view it is a gift from God just as well as this island and the coconut trees are gifts from God. I don't think we should subtract any of God's gifts when we measure our wealth".

The young man still didn't like the idea of counting virtual coconuts - pieces of paper - as wealth. But he didn't know what to answer and left the hogons hut.

Some time after this talk the young man had a dream himself. Whether it came from God or the Devil he couldn't tell. He saw himself easily entering a coconut tree along something he had never seen before - he later called it a ladder. He thought that entering a tree by a ladder looked smart and would impress the women, so he decided to use part of his time building a ladder - to be precise, one quarter of his time. Consequently, he picked only  $3/4$  of the coconuts he used to pick and as he consumed as many as before, he only delivered half as many - one quarter of his harvest - to the hogon's hut. But he didn't bother. He reasoned that when he got old he could sell his ladder to a young man in return for a constant delivery of coconuts for the rest of his lifetime, thereby making up for the fact that he had delivered fewer coconuts to the hogon and consequently had fewer IOUs. And he was right. He had no difficulty in selling his ladder and his standard of living as old was unaffected. As time passed more and more young men copied his idea and eventually all had ladders.

But the hogan got in deep troubles. When the young men started to deliver fewer coconuts the hogan could no longer fulfil his obligations towards the old people. "Sorry", he said, "but I can only pay you a fraction of a coconut for each IOU you return to me". They got angry, but could do nothing about it. And the fraction of a coconut they got in return for each IOU continued to fall until all the young men had got a ladder. At that time it had fallen to one half.

The event caused a lot of palaver at the general meeting. Naturally, the old felt cheated. But they were sophisticated and instead of complaining over their own fate they argued that building ladders had reduced the production of coconuts and, consequently, had been bad for the island as a whole

However, they were silenced by a young man who was so sharp and eloquent, that the villagers called him Diamond.

"First", Diamond argued, "total production has not fallen. It is true that we have produced fewer coconuts, but instead of coconuts we produced ladders, i.e. we invested in capital goods. The value of the ladders measured in coconuts corresponds exactly to the coconuts we could have produced, so total production remained constant. Production that is not consumed is saved. The more we save, the more we invest, and the more we invest the larger our stock of capital will grow".

"Second, he went on", it is true that the purchasing power of your IOUs has shrunk. But IOUs are no part of real wealth. They are just one hand's outstanding debts to the other. It is only real capital that counts, so it is only through investment that we can get rich. Today the village has a stock of real capital corresponding to 1/4 of one generation's production. Before we started to invest in ladders, we had none. So you must admit that the village as such has become richer."

The hogan didn't argue against Diamond. The villagers's respect of the hogan had dwindled with the value of the IOUs and they wouldn't listen to him. He just shook his head. But back in his hut he talked to God and said, "They are simpleminded people. They don't understand what they don't see. They don't realize that you created their wealth by a miracle by telling them to issue IOUs. They have not grasped that your gift is a grace that cannot be enlarged by building tangible symbols of wealth. The more of tangible capital they collect the more of your undeserved intangible gift they destroy. Forgive them their ignorance and be patient. One day they will understand and turn their back against Diamond and the idolatry, he preaches".

It so befell as he had predicted. After some time the young men changed their mood. Using ladders became regarded as old-fashioned and lax. Climbing the trees without ladders exposed the young men's muscles and strength and both the young men and the young women liked that. So the young men didn't any longer want to buy ladders from the old people, and the price of ladders in terms of coconuts fell to zero. Instead they brought twice as many coconuts to the hogan's hut. For each coconut they got two IOUs as had become the current price".

The hogan now got twice as many coconuts as he needed to meet the old people's demand. He shortly considered to reduce the price of coconuts to one

IOU. That would make it possible for the old people to prevail their standard of living and would not hurt the young men. But he skipped the idea; it would be too difficult to explain to the villagers. So he kept the prevailing price of coconuts unchanged - two IOUs for one coconut. Instead he proclaimed a welfare program: Due to the mercy of God the hogan would grant compensation to the old people for the loss in wealth they had suffered because the failing demand for ladders had made their capital worthless. And all the villagers praised God and the hogan for his charity.

The old and now useless and worthless ladders lay astray on the island. Most islanders considered them junk and a disfiguration of their beautiful island. So the hogan told them to collect the ladders and place them in a pile on the beach for the children to play with. Here they gradually disintegrated. No capital good is so durable that it can stand the wear of playing children.

Only two ladders were kept for the future. They were exposed in front of the hogan's hut in what he called "Museum of capital idolatry" as a warning to future generation and in memory of the people who had suffered from Diamond's false teaching. - And here they can still be seen, if nobody has removed them.