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The Inequality Puzzle

Thomas Piketty's tour de force analysis doesn't get everything right, but it's certainly gotten us pondering the right questions.

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Capital in the Twenty-First Century by Thomas Piketty; Translated by Arthur Goldhammer • Belknap/Harvard University Press • 2014 • 696 pages • \$39.95

Once in a great while, a heavy academic tome dominates for a time the policy debate and, despite bristling with footnotes, shows up on the best-seller list. Thomas Piketty's *Capital in the Twenty-First Century* is such a volume. As with Paul Kennedy's *The Rise and Fall of the Great Powers*, which came out at the end of the Reagan Administration and hit a nerve by arguing the case against imperial overreach through an extensive examination of European history, Piketty's treatment of inequality is perfectly matched to its moment.

Like Kennedy a generation ago, Piketty has emerged as a rock star of the policy-intellectual world. His book was for a time Amazon's bestseller. Every pundit has expressed a view on his argument, almost always wildly favorable if the pundit is progressive and harshly critical if the pundit is conservative. Piketty's tome seems to be drawn on a dozen times for every time it is read.

This should not be surprising. At a moment when our politics seem to be defined by a surly middle class and the President has made inequality his central economic issue, how could a book documenting the pervasive and increasing concentration of wealth and income among the top 1, .1, and .01 percent of households *not* attract great attention? Especially when it exudes erudition from each of its nearly 700 pages, drips with literary references, and goes on to propose easily understood laws of capitalism that suggest that the trend toward greater concentration is inherent in the market system and will persist absent the adoption of radical new tax policies.

Piketty's timing may be impeccable, and his easily understandable but slightly exotic accent perfectly suited to today's media; but make no mistake, his work richly deserves all the attention it is receiving. This is not to say, however, that all of its conclusions will stand up to scholarly

criticism from his fellow economists in the short run or to the test of history in the long run. Nor is it to suggest that his policy recommendations are either realistic or close to complete as a menu for addressing inequality.

Start with its strengths. In many respects, *Capital in the Twenty-First Century* embodies the virtues that we all would like to see but find too infrequently in the work of academic economists. It is deeply grounded in painstaking empirical research. Piketty, in collaboration with others, has spent more than a decade mining huge quantities of data spanning centuries and many countries to document, absolutely conclusively, that the share of income and wealth going to those at the very top—the top 1 percent, .1 percent, and .01 percent of the population—has risen sharply over the last generation, marking a return to a pattern that prevailed before World War I. There can now be no doubt that the phenomenon of inequality is not dominantly about the inadequacy of the skills of lagging workers. Even in terms of income ratios, the gaps that have opened up between, say, the top .1 percent and the remainder of the top 10 percent are far larger than those that have opened up between the top 10 percent and average income earners. Even if none of Piketty's theories stands up, the establishment of this fact has transformed political discourse and is a Nobel Prize-worthy contribution.

Piketty provides an elegant framework for making sense of a complex reality. His theorizing is bold and simple and hugely important if correct. In every area of thought, progress comes from simple abstract paradigms that guide later thinking, such as Darwin's idea of evolution, Ricardo's notion of comparative advantage, or Keynes's conception of aggregate demand. Whether or not his idea ultimately proves out, Piketty makes a major contribution by putting forth a theory of natural economic evolution under capitalism. His argument is that capital or wealth grows at the rate of return to capital, a rate that normally exceeds the economic growth rate. Thus, economies will tend to have ever-increasing ratios of wealth to income, barring huge disturbances like wars and depressions. Since wealth is highly concentrated, it follows that inequality will tend to increase without bound until a policy change is introduced or some kind of catastrophe interferes with wealth accumulation.

Piketty writes in the epic philosophical mode of Keynes, Marx, or Adam Smith rather than in the dry, technocratic prose of most contemporary academic economists. His pages are littered with asides referencing Jane Austen, the works of Balzac, and many other literary figures. For those who don't like or trust economics and economists, Piketty's humane and urbane learning makes his analysis that much more compelling. As well it should: The issues of fairness of market outcomes that he deals with are best thought of as part of a broad contemplation of our society rather than in narrow numerical terms.

All of this is more than enough to justify the rapturous reception accorded Piketty in many quarters. But recall that Kennedy seemed to hit the zeitgeist perfectly but turned out later to have missed his mark as the Berlin Wall fell and the United States enjoyed an economic renaissance in the decade after he wrote; similarly, I have serious reservations about Piketty's theorizing as a guide to understanding the evolution of American inequality. And, as even Piketty himself recognizes, his policy recommendations are unworldly—which could stand in the way of more feasible steps that could make a material difference for the middle class.

Piketty's argument is straightforward, relying, as he says in his conclusion, on a simple inequality: $r > g$, in which the rate of return on capital exceeds the growth rate. Its essence is most easily grasped by thinking about population growth. Think first of a world where couples have four children. In that case, an accumulated fortune will dissipate, as the third generation of descendants has 64 members and the fourth has 256 members. On the other hand, if couples have only two children, a fortune has to be split only 16 ways even after four generations. So slow growth is especially conducive to rising levels of wealth inequality, as is a high rate of return on capital that accelerates wealth accumulation. Piketty argues that as long as the return to wealth exceeds an economy's growth rate, wealth-to-income ratios will tend to rise, leading to increased inequality. According to Piketty, this is the normal state of capitalism. The middle of the twentieth century, a period of unprecedented equality, was also marked by wrenching changes associated with the Great Depression, World War II, and the rise of government, making the period from 1914 to 1970 highly atypical.

This rather fatalistic and certainly dismal view of capitalism can be challenged on two levels. It presumes, first, that the return to capital diminishes slowly, if at all, as wealth is accumulated and, second, that the returns to wealth are all reinvested. Whatever may have been the case historically, neither of these premises is likely correct as a guide to thinking about the American economy today.

Economists universally believe in the law of diminishing returns. As capital accumulates, the incremental return on an additional unit of capital declines. The crucial question goes to what is technically referred to as the elasticity of substitution. With 1 percent more capital and the same amount of everything else, does the return to a unit of capital relative to a unit of labor decline by more or less than 1 percent? If, as Piketty assumes, it declines by less than 1 percent, the share of income going to capital rises. If, on the other hand, it declines by more than 1 percent, the share of capital falls.

Economists have tried forever to estimate elasticities of substitution with many types of data, but there are many statistical problems. Piketty argues that the economic literature supports his assumption that returns diminish slowly (in technical parlance, that the elasticity of substitution is greater than 1), and so capital's share rises with capital accumulation. But I think he misreads the literature by conflating gross and net returns to capital. It is plausible that as the capital stock grows, the increment of output produced declines slowly, but there can be no question that depreciation increases proportionally. And it is the return net of depreciation that is relevant for capital accumulation. I know of no study suggesting that measuring output in net terms, the elasticity of substitution is greater than 1, and I know of quite a few suggesting the contrary.

There are other fragmentary bits of evidence supporting this conclusion that come from looking at particular types of capital. Consider the case of land. In countries where land is scarce, like Japan or the United Kingdom, land rents represent a larger share of income than in countries like the United States or Canada, where it is abundant. Or consider the case of housing. Economists are quite confident that the demand for housing is inelastic, so that as more housing is created, prices fall more than proportionally—a proposition painfully illustrated in 2007 and 2008.

Does not the rising share of profits in national income in most industrial countries over the last several decades prove out Piketty's argument? Only if one assumes that the only factors at work are the ones he emphasizes. Rather than attributing the rising share of profits to the inexorable process of wealth accumulation, most economists would attribute both it and rising inequality to the working out of various forces associated with globalization and technological change. For example, mechanization of what was previously manual work quite obviously will raise the share of income that comes in the form of profits. So does the greater ability to draw on low-cost foreign labor.

There is also the question of whether the returns to wealth are largely reinvested. A central claim by Piketty is that a country's wealth-income ratio tends toward s/g , the ratio of its savings rate to its growth rate. Hence, as he argues, a declining growth rate leads to a higher wealth ratio. But this presumes a constant or rising saving ratio. Since he imagines returns to capital as largely reinvested, he finds this a plausible assumption.

I am much less sure. At the simplest level, consider a family with current income of 100 and wealth of 100 as opposed to a family with current income of 100 and wealth of 500. One would expect the former family to have a considerably higher saving ratio. In other words, there is a self-correcting tendency Piketty abstracts from whereby rising wealth leads to declining saving.

The largest single component of capital in the United States is owner-occupied housing. Its return comes in the form of the services enjoyed by the owners—what economists call “imputed rent”—which are all consumed rather than reinvested since they do not take a financial form. The phenomenon is broader. The determinants of levels of consumer spending have been much studied by macroeconomists. The general conclusion of the research is that an increase of \$1 in wealth leads to an additional \$.05 in spending. This is just enough to offset the accumulation of returns that is central to Piketty's analysis.

A brief look at the *Forbes* 400 list also provides only limited support for Piketty's ideas that fortunes are patiently accumulated through reinvestment. When *Forbes* compared its list of the wealthiest Americans in 1982 and 2012, it found that less than one tenth of the 1982 list was still on the list in 2012, despite the fact that a significant majority of members of the 1982 list would have qualified for the 2012 list if they had accumulated wealth at a real rate of even 4 percent a year. They did not, given pressures to spend, donate, or misinvest their wealth. In a similar vein, the data also indicate, contra Piketty, that the share of the *Forbes* 400 who inherited their wealth is in sharp decline.

But if it is not at all clear that there is any kind of iron law of capitalism that leads to rising wealth and income inequality, the question of how to account for rising inequality remains. After Piketty and his colleagues' work, there can never again be a question about the phenomenon or its pervasiveness. The share of the top 1 percent of American income recipients has risen from below 10 percent to above 20 percent in some recent years. More than half of the income gains enjoyed by Americans in the twenty-first century have gone to the top 1 percent. The only groups that have outpaced the top 1 percent have been the top .1 and .01 percent.

Piketty, being a meticulous scholar, recognizes that at this point the gains in income of the top 1 percent substantially represent labor rather than capital income, so they are really a separate issue from processes of wealth accumulation. The official data probably underestimate this aspect—for example, some large part of Bill Gates's reported capital income is really best thought of as a return to his entrepreneurial labor.

So why has the labor income of the top 1 percent risen so sharply relative to the income of everyone else? No one really knows. Certainly there have been changes in prevailing mores regarding executive compensation, particularly in the English-speaking world. It is conceivable, as Piketty argues, that as tax rates have fallen, executives have gone to more trouble to bargain for super high salaries, effort that would not have been worthwhile when tax rates were high (though I think it is equally plausible that higher tax rates would pressure executives to extract more, so as to maintain their post-tax income levels).

There is plenty to criticize in existing corporate-governance arrangements and their lack of resistance to executive self-dealing. There are certainly abuses. I think, however, that those like Piketty who dismiss the idea that productivity has anything to do with compensation should be given a little pause by the choices made in firms where a single hard-nosed owner is in control. The executives who make the most money are not for most part the ones running public companies who can pack their boards with friends. Rather, they are the executives chosen by private equity firms to run the companies they control. This is not in any way to ethically justify inordinate compensation—only to raise a question about the economic forces that generate it.

The rise of incomes of the top 1 percent also reflects the extraordinary levels of compensation in the financial sector. While anyone looking at the substantial resources invested in trading faster by nanoseconds has to worry about the over-financialization of the economy, much of the income earned in finance does reflect some form of pay for performance; investment managers are, for example, compensated with a share of the returns they generate.

And there is the basic truth that technology and globalization give greater scope to those with extraordinary entrepreneurial ability, luck, or managerial skill. Think about the contrast between George Eastman, who pioneered fundamental innovations in photography, and Steve Jobs. Jobs had an immediate global market, and the immediate capacity to implement his innovations at very low cost, so he was able to capture a far larger share of their value than Eastman. Correspondingly, while Eastman's innovations and their dissemination through the Eastman Kodak Co. provided a foundation for a prosperous middle class in Rochester for generations, no comparable impact has been created by Jobs's innovations.

This type of scenario is pervasive. Most obviously, the best athletes and entertainers benefit from a worldwide market for their celebrity. But something similar is true for those with extraordinary gifts of any kind. For example, I suspect we will soon see the rise of educator superstars who command audiences of hundreds of thousands for their Internet courses and earn sums way above the traditional dreams of academics.

Even where capital accumulation is concerned, I am not sure that Piketty's theory emphasizes the right aspects. Looking to the future, my guess is that the main story connecting capital

accumulation and inequality will not be Piketty's tale of amassing fortunes. It will be the devastating consequences of robots, 3-D printing, artificial intelligence, and the like for those who perform routine tasks. Already there are more American men on disability insurance than doing production work in manufacturing. And the trends are all in the wrong direction, particularly for the less skilled, as the capacity of capital embodying artificial intelligence to replace white-collar as well as blue-collar work will increase rapidly in the years ahead.

Where does this leave policy?

Piketty's argument is that a tendency toward wealth accumulation and concentration is an inevitable byproduct of the workings of the capitalist system. From his perspective, differences between capitalism as practiced in the English-speaking world and in continental Europe are of second order relative to the underlying forces at work. So he is led to far-reaching policy proposals as the principal redress for rising inequality.

In particular, Piketty argues for an internationally enforced progressive wealth tax, where the rate of tax rises with the level of wealth. This idea has many problems, starting with the fact that it is unimaginable that it will be implemented any time soon. Even with political will, there are many problems of enforcement. How does one value a closely held business? Even if a closely held business could be accurately valued, will its owners be able to generate the liquidity necessary to pay the tax? Won't each jurisdiction have a tendency to undervalue assets within it as a way of attracting investment? Will a wealth tax encourage unseemly consumption by the wealthy?

Perhaps the best way of thinking about Piketty's wealth tax is less as a serious proposal than as a device for pointing up two truths. First, success in combating inequality will require addressing the myriad devices that enable those with great wealth to avoid paying income and estate taxes. It is sobering to contemplate that in the United States, annual estate and gift tax revenues come to less than 1 percent of the wealth of just the 400 wealthiest Americans. With respect to taxation, as so much else in life, the real scandal is not the illegal things people do—it is the things that are legal. And second, such efforts are likely to require international cooperation if they are to be effective in a world where capital is ever more mobile. The G-20 nations working through the OECD have begun to address these issues, but there is much more that can be done. Whatever one's views on capital mobility generally, there should be a consensus on much more vigorous cooperative efforts to go after its dark side—tax havens, bank secrecy, money laundering, and regulatory arbitrage.

Beyond taxation, however, there is, one would hope, more than Piketty acknowledges that can be done to make it easier to raise middle-class incomes and to make it more difficult to accumulate great fortunes without requiring great social contributions in return. Examples include more vigorous enforcement of antimonopoly laws, reductions in excessive protection for intellectual property in cases where incentive effects are small and monopoly rents are high, greater encouragement of profit-sharing schemes that benefit workers and give them a stake in wealth accumulation, increased investment of government pension resources in riskier high-return assets, strengthening of collective bargaining arrangements, and improvements in corporate governance. Probably the two most important steps that public policy can take with respect to wealth inequality are the strengthening of financial regulation to more fully eliminate implicit

and explicit subsidies to financial activity, and an easing of land-use restrictions that cause the real estate of the rich in major metropolitan areas to keep rising in value.

Hanging over this subject is a last issue. Why is inequality so great a concern? Is it because of the adverse consequences of great fortunes or because of the hope that middle-class incomes could grow again? If, as I believe, envy is a much less important reason for concern than lost opportunity, great emphasis should shift to policies that promote bottom-up growth. At a moment when secular stagnation is a real risk, such policies may include substantially increased public investment and better training for young people and retraining for displaced workers, as well as measures to reduce barriers to private investment in spheres like energy production, where substantial job creation is possible.

Look at Kennedy airport. It is an embarrassment as an entry point to the leading city in the leading country in the world. The wealthiest, by flying privately, largely escape its depredations. Fixing it would employ substantial numbers of people who work with their hands and provide a significant stimulus to employment and growth. As I've written previously, if a moment when the United States can borrow at lower than 3 percent in a currency we print ourselves, and when the unemployment rate for construction workers hovers above 10 percent, is not the right moment to do it, when will that moment come?

Books that represent the last word on a topic are important. Books that represent one of the first words are even more important. By focusing attention on what has happened to a fortunate few among us, and by opening up for debate issues around the long-run functioning of our market system, *Capital in the Twenty-First Century* has made a profoundly important contribution. **D**