(Re)Booting the Dismal Science

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Thomas Piketty, **Capital in the Twenty-First Century** (2014).

French economist Thomas Piketty has published a lengthy tome on economics that, unusual for economics books, has become a best seller. That attention is for good cause. While not exactly a beach read, *Capitalism in the Twenty-First Century* is a potential game changer for what the study of economics entails and its consequence for future policies. The timing of the book is perfect because the fact of increasing economic inequality has become a topic of increasing focus among academics but also in public policy discussions more broadly. What has been lacking is a deep understanding of how this has come to happen and what might be done to reduce inequality. Picketty's book moves the discussion forward by pointing to where inequality comes from, where it is going, what might be done to shift its momentum and direction and what might happen if nothing is done to alleviate ever increasing inequality.

In his Introduction, Piketty quotes Marx's "Communist Manifest" for its prediction of the inevitability of revolution resulting from the internal contradiction of capitalism: "The development of Modern Industry, therefore, cuts from under its feet the very foundation on which the bourgeoisie produces and appropriates products. What the bourgeoisie therefore produces, above all, are its own gravediggers. Its fall and the victory of the proletariat are equally inevitable." In less dramatic language, Piketty concludes that "the private rate of return on capital, *r,* can be significantly higher for long periods of time than the rate of growth of income and output, *g*. The inequality *r>g* implies that wealth accumulated in the past grows more rapidly than output and wages. . . . Once constituted, capital reproduces itself faster than output increases. The past devours the future." His evidence supporting his conclusion that makes capitalism inherently unstable, at least in its present form, is his of study of a wide array of data from a number of countries from the 19th century up until the beginning of World War I and, beginning again after the end of World War II until today. During those prolonged periods, the net rate of economic growth in terms of output and wages was about 1% while the return on capital was always between 4 and 5%. Thus, wealth in terms of capital versus from labor increasingly is concentrated in the top 1% and, even more so, in the top .01%. Ever-expanding capital simply cannot be sustained in the long run because that would mean that labor loses all value. If the past is the prologue to the future, capitalism will at some point inevitably collapse if actions are not taken to reduce the growing value of capital. The period from the beginning of World War I through the end of the immediate post-World War II period demonstrated that the momentum toward ever increasing concentration of wealth can be stopped. During that disastrous period of the 20th century, there was a substantial shift as capital shrank due to the destruction of the two great wars, the Great Depression, the end of European colonization and a policy shift toward the creation of a middle class. As a result economic inequality decreased significantly until after World War II. Much economic theory assumed that this period was the new normal, but, for Piketty, the experience since 1970 onward shows that the old normal has reasserted itself so that economic inequality will continue to grow unless substantial efforts are undertaken to change the policies that underpin the growing power of capital over labor.

Where Piketty differs from Marx is that he does not agree that the end of capitalism is inevitable or that capitalism is inherently contradictory. Instead of Marx's economic determinism, Piketty believes in capitalism and a globalized economy but he concludes that the present situation is the result of policy choices that have been made. For him, disaster can be averted if those policies are altered to change the course of the present trend toward ever increasing economic inequality.

There has been and will continue to be, I am sure, extensive debate about his thesis and the data he has assembled to support it. But, I want to explain why this book has much broader potential impact, even if his analysis and conclusion might not ultimately be accepted in whole or even in substantial part. There are three reasons why this book is likely to have long term significance, even beyond the conclusions that Piketty draws from his studies. The first concerns the proper scope of economics as a discipline. In 1962, Milton Friedman published “Capitalism and Freedom” that was the opening shot in the war to replace Keynesian macroeconomics with free market microeconomics—the Chicago School. With tremendous support from those economic interests that would benefit from neoliberal economic theory and governmental policies based on that theory, free market microeconomics won the war in the United States and it has had a tremendous impact globally as well. Piketty challenges that narrow view of what is properly called economics by reasserting the significance of macroeconomic theory as a proper basis not only for the study of economics as an academic discipline but also to make economic policy decisions.

Second, Piketty is convinced that the true study of economics is a social science. To be a social science and to be potentially meaningful, economics must be based on the best and broadest available data, and not just theory. To support a return to that broader view of what economics is all about, Piketty looks to history and, more importantly, to all kinds of sources of economic data developed both internationally and—so far, more significantly—within different national economies. In short, he wants to transform economics from pure theory to join other social sciences, such as sociology, that are based on data and its analysis. Chicago School economics has recently been at least dinged, if not seriously undermined, by the emergence of microeconomic behavioral economics that studies data showing how people make economic decisions rather than the hypothetical “rational economic actors” that drive pure Chicago School economic theory. Piketty shows that analyzing vast amounts of macroeconomic data is key to making the study of economics realistic and therefore useful. He, of course, calls for amassing much more data of different types especially from much more of the world including the developing and undeveloped nations of the world.

Third, Piketty rejects the parochialism of economics that focus on individual national economies. He takes a global perspective on how economic theory and policy should be discussed. Given the expanding significance of global economic activity, this seems obvious. Most of his analysis is based on major developed national economies because the U.S., the U.K., France, Germany, Japan, and Sweden have the data that have been collected that can be used for his comparative analyses. But he uses any data he can find to project the way globalized economics works. Would more data come available from the developing world, Piketty would incorporate that in his approach to economics.

The book is well written, surprisingly so considering it is a translation from the French, but it is long. Piketty presents a vast array of historical and current data of widely different forms and includes data from 20 countries. His descriptions along with accompanying graphs and tables are extremely clear. Based on the data presented, Piketty presents a wide variety of different interpretations and he does a good job supporting the conclusions that he draws from these mountains of information.

Publication of *Capital in the Twenty-First Century* has resulted in a significant amount of response, much of it favorable but also a lot of criticism. The criticism takes two basic forms—challenges to his data and to the inferences that he draws based on that data. So far, the most significant attack on Piketty’s methodology for presenting and interpreting data has been by the Financial Times economics editor, Chris Giles. Some of the criticisms involve what Giles considers to be “transcription errors from the original sources and incorrect formulas.” Piketty has explained these not as errors but as necessary judgment calls based on limitations inherent in the way the different sources of data have been made available and how best to interpret them overall. More seriously, Giles claims that Piketty misinterprets data from the U.K. so that Piketty’s conclusion that inequality is increasing is unsupported and in fact economic inequality is not increasing in the U.K. Piketty responds that Giles fails to understand the difference between tax data and survey data about wealth. According to Piketty, Giles is comparing the apples of hard tax data with the oranges of much softer survey data. Survey data understates wealth because people have a strong tendency to underreport what they own. Given the tremendous amount and range of data that Piketty has assembled, the immediate future of Piketty’s approach will depend on how reviews of his methodology turn out. In his response to Giles, Piketty appears to have so far won the debate, but it is still very early. If nothing else, *Capital in the Twenty-First Century* is likely to set the agenda for economic researchers for the foreseeable future.

A number of critics have challenged the inferences that Piketty has drawn based on the data he has presented. For example, Larry Summers is not so sure that Piketty's conclusion that the recent extraordinary increases in CEO compensation in the United States is the result of our low income tax rates that create incentives for CEOs to seek ever higher compensation. Piketty bases his conclusion on the fact that productivity of U.S. corporations has not increased to justify higher executive compensation and that CEO compensation of multi-national corporations located in other developed countries with higher income tax rates has not ballooned as they are doing in the U.S., even though the productivity of their corporations is in line with U.S.-based corporations. As with challenges to the data Piketty has presented, his inferences will also form the agenda for economic researchers in the near and perhaps far term.

Capital in the Twenty-First Century is important to read because it has already altered the focus of economic debate. Its longer term significance depends on how it holds up to the many critics who have a new research agenda based on what Piketty has done.

Piketty's policy conclusions will make people like Grover Norquist gasp in horror. For example, Piketty concludes that "the optimal top tax rate in the developed countries is probably above 80 percent." He concludes that income tax rates that high would not interfere with the growth of economic productivity and would, in the U.S., go a long way toward reducing the present growth in economic inequality that is primarily based on unjustified rent seeking by the high executive class. Even more shocking to the present conventional wisdom is Piketty's proposal for a worldwide tax on net wealth that is accompanied by international laws and policies to minimize the ability of taxpayers to hide their assets in tax havens.

Given the present state of political discussion, Piketty's proposals sound shocking. But, there is a great jazz song, "Compared to What," recorded in 1969 by pianist Les McCann and saxophonist Eddie Harris for their album, *Swiss Movement*. Doing something to reduce economic inequality has to be compared with what will happen if nothing is done. Piketty explains that the last time economic inequality was as extreme as it is today was in the Gilded Age, as it is described in the U.S., and the Belle Époque as the period was called in Europe. What reversed that inequality was the horror of the two world wars and the Great Depression. If the alternative to dealing with ever increasing economic inequality is such catastrophes, perhaps we can begin to discuss policy approaches that are not nearly so destructive. If Piketty's analysis is right and nothing is done, what will be dismal is the failure of humankind to protect its future.

Editor's note: For other Jotwell reviews of Thomas Piketty's **Capital in the Twenty-First Century** see:

- Neil H. Buchanan, Thomas Piketty's Book Is Masterful and Important, but Ultimately a Sideshow (Tax)
- Kent D. Schenkel, Trusts and Estates Law and the Question of Wealth Distribution (Trusts & Estates)
- Daniel Shaviro, The Return of Capital (Tax)

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