The Piketty Bubble

*Capital in the Twenty-First Century* suits the political zeitgeist, writes Julie Novak, but it fails as an intellectual basis for tackling inequality.
Arguably the great surprise of 2014 so far would have to be the literary juggernaut that is *Capital in the Twenty-First Century*, originally written in 2013 by little known French economist Thomas Piketty and subsequently translated into English.

The most surprising element is that the book is an international best seller, especially in the United States. It achieved status as the top seller on Amazon.com, a rarity for a book strictly situated within the broad confines of political economy. Although it has been reported that sales of the book have picked up somewhat recently in Piketty’s native France, a country whose public policies are heavily informed by redistributionist concerns, according to a journalist for a left wing journal *Capital’s* spiralling US book sales even ‘has the French scratching their heads.’

Along with the skyrocketing sales for a political economy tract is the curiosity that Piketty’s work has spawned its own thriving industry of laudatory book reviews. Prominent Keynesian economist Paul Krugman declared *Capital* to be a ‘magnificent, sweeping meditation on inequality’ which illustrates that ‘we haven’t just gone back to nineteenth century levels of income inequality, we’re also on a path back to “patrimonial capitalism,” in which the commanding heights of the economy are controlled not by talented individuals but by family dynasties.’

In late April 2014, the editors of *Esquire* magazine chose to eclipse Krugman’s lavish praise by declaring *Capital* to be ‘the most important book of the century.’ The *Economist* stated *Capital* represents ‘the authoritative guide’ on inequality, historian Andrew Hussey claimed the book proved the anti-inequality protests of the Occupy Movement correct, and even neoclassical growth economist Robert Solow complimented the Piketty work.

Thomas Piketty’s basic idea is that current inequality is caused by the fact that two key economic variables grow at different rates.

The first is the annual growth rate of total income or output created in the economy \(g\). The second is the average annual rate of return on capital \(r\), which in turn includes profits, dividends, interest rates, rents, and other incomes from capital. Piketty suggests that \(r > g\) is the ‘fundamental force for divergence’ which exacerbates observed inequalities: ‘when the rate of return on capital significantly exceeds the growth rate of the economy … then it logically follows that inherited wealth grows faster than output and income.’

Whilst Piketty does not offer a thesis concerning the inevitability of divergence in the share of wealth and incomes within advanced economies, he claims the possibilities of a tendency towards divergence ‘are not heartening’ and, indeed, warns of a tendency towards extreme inequality during the twenty first century. The speculative conclusion of a ‘terrifying’ escalation in the degree of inequality out to 2100, as stated in *Capital*, are undoubtedly controversial, but initially the general consensus was that Piketty at least provided the economics profession a service by providing a panoramic depiction of historical inequality trends in the Western world.

That was until economic historians and journalists dug more deeply into the Piketty dataset, and uncovered potential problems. In a series of blog posts, economic historian Phillip Magness pointed out several irregularities of significance with the Piketty data, including the absence of wealth and
income data points across numerous decades in the sample, and an inclination to convert data into decennial averages which, in turn, risks masking the effects of important variations over time.

Chris Giles, a journalist for Britain’s Financial Times newspaper, subsequently found a number of apparent coding errors in Piketty’s publicly available spreadsheets, some unexplained modifications to data from various sources, the use of simple (rather than weighted) averages, questionable data interpolation, and definitional problems.

In fairness, one could afford Piketty some leeway with regard to coding errors as well as the difficult judgments which need to be made with regard to wealth and income data selection, even if (as an aside) such leeway was arguably not necessarily given to the economists Carmen Reinhart and Kenneth Rogoff last year with regard to errors identified in their modelling of the relationship between public debt and growth.

Even if one gives Piketty the benefit of the doubt in a spirit of intellectual forbearance, there remain several outstanding conceptual problems inherent within Capital which are much more difficult to avoid.

One of the more obvious drawbacks of Piketty’s analysis is that capital is depicted as an aggregated glob of homogenous character, which essentially reproduces itself and is almost assured of generating a positive return regardless of circumstances, aside from war or major catastrophes. This characterisation of capital is in sharp contrast with other approaches, especially that of the Austrian school of economics, which places great emphasis, as economist Peter Klein put it recently, upon ‘the complexity, variety, and quality of the economy’s capital structure’.

From the Austrian descriptions about the inherent heterogeneity of capital comes a micro level narrative that stresses the primacy of entrepreneurial decision making under uncertainty, whereby entrepreneurs creatively acquire, utilise and combine costly capital goods with other production factors (such as land, finances, and labour) in the pursuit of profitable economic opportunities.

Apart from the quite indiscriminate classification of both financial assets and capital goods as ‘capital’ in Piketty’s book, the notion that capital owners earning a positive rate of return on the use of their justly acquired capital goods is somehow a cause for concern is dispelled by basic economic and financial theories.

Piketty acknowledges that ‘capital invested in business is of course at greater risk, so the average return is often higher,’ but by the same token makes the sweeping generalisation that ‘the entrepreneur inevitably tends to become a rentier, more and more dominant over those who own nothing but their labour. Once constituted, capital reproduces itself faster than output increases. The past devours the future.’ But as former Governor of the Bank of England, Mervyn King, recently put it, ‘the main reason for the average rate of return exceeding the growth rate by a good margin is that savers require a risk premium to compensate for the uncertain nature of the returns on investment. Adjusting for risk, average rates of return have historically been much closer to growth rates.’

Sharply contrasting Capital’s image of the entrepreneur as a privileged, complacent rentier sitting atop a pile of capital as the money automatically pours in is the reality that heterogeneous and complex capital can only generate returns when used creatively and productively, in combination with other resources. In market oriented economies it is only through the creative, yet at the same time costly, efforts of entrepreneurs to produce value that leads to wealth impermanence as shown by a high rate of churning within wealthy ‘rich lists’, a redefinition of poverty in the developed world to mean the absence of a plasma television at home, and, incidentally, positive rates of return on capital as well as economic growth.

To counter the ‘implacable logic’ of annual rates of return on capital outstripping annual economic growth rates in an inequality spiral, Piketty challenges his readers to embrace much heavier, and more progressive, taxation burdens on income and inherited wealth. Specifically, he suggests for the United States an income tax rate of 80 per cent of incomes of above $500,000 or $1 million, heftier income taxes of 50 or 60 per cent on incomes above $200,000, annual domestic wealth taxes ranging from 10 per cent to 20 per cent, and international coordination on the wealth tax front.

Without any hint of irony Piketty rationalises such a tax regime as a way ‘to put an end to such incomes of large estates,’ yet claims there is no absolute prohibition or expropriation. The progressive tax is thus a relatively liberal method for reducing inequality, in the sense that free competition and private property are respected while private incentives are modified in potentially radical ways, but always according to rules thrashed out in democratic debate.
The great trouble with the confiscatory taxation project is that it might dampen rates of return on capital, but would also serve to radically reduce the rate of growth in Piketty’s grand inequality identity, thus reducing opportunities for all people, rich and poor, to enjoy long term improvements in their living standards.

It should be recalled that, apart from some troubling partial reversals on policy since the 2008-09 global financial crisis (GFC), the general trend throughout much of the West since the 1970s has been for income, capital and wealth taxation rates to fall, in some cases quite appreciably, and for rate structures to become less progressive.

Therefore, and in no uncertain terms, Thomas Piketty’s Capital in the Twenty-First Century represents a clarion call to take our taxation policies, our economic growth and productivity potentials, and respectability given to entrepreneurs and workers to keep more of their own justly acquired earnings and wealth, back four decades.

Until a few years ago the Piketty message would not have resonated anywhere, with the exception of perhaps France or Scandinavia, but since the GFC a bevy of progressive politicians and religious figures have espoused redistribution as the central objective of our times.

US President Barack Obama stated late last year that he would make redressing ‘dangerous and growing inequality and lack of upward mobility’ his primary domestic policy focus for the remainder of his presidential term.

Pope Francis took to social media in late April to state that ‘inequality is the root of social evil,’ and has called for ‘the legitimate redistribution of economic benefits by the state’ as a crucial aspect of a global movement toward ‘equitable economic and social progress.’

So, in a classic case of confirmation bias, Piketty’s book just so happens to neatly conform with the redistributionist’s brief.

As much as the overwrought hype in favour of Capital reflects an incessant thirst by some for intellectual reinforcement of a forcible transfers agenda, which has dominated in various guises since modern socialism’s inception, it still does not answer the fundamental question: why has inequality, and Piketty’s purported solution to it, become the policy flavour of the month?

A speculative attempt at answering this question comes in two parts.

First, when the capacity for people, regardless of their economic, financial and social circumstances, to pursue their material aspirations diminish by virtue of slowing economic growth and flagging productivity improvements, they divert their acquisitive efforts toward gaming the political process in their favour against their fellows, in the name of stamping out inequality.

There is little question that the growth trajectory of Western economies has been uninspiring as of late, and Piketty has gone so far as to predict a slowing of growth in major countries over the remainder of this century.

These efforts, however, represent something of a double edged sword. On the one hand, the benefits of economic growth for rich and poor alike are emasculated by the raft of distortionary taxes, prescriptive regulations, and wasteful spending accumulated over several decades, but, on the other, demands for more government intervention to redress inequality curtail the very capacity of the fiscal system to deliver largesse to political constituencies.

Second, the political left have been grasping for an agenda that could potentially capture the attention of the masses since the fall of the Soviet Empire in the late 1980s and early 1990s struck a blow against the reputation of socialist central planning of entire economies.

Using the coercive instruments at the disposal of the state to punish the wealthy and privilege those not so wealthy has become the defining cause of the post-GFC zeitgeist, not least since it feeds into some aspect of the mindset within all of us seeking to enshrine some modicum of fairness among human beings. And the inequality agenda pushed by Piketty’s Capital fits into those deeply ingrained biases in ways that thematic rivals of the left’s new agenda, such as global warming scaremongering and nanny state paternalism, cannot.

But in the end, Piketty provides his mass audience of adherents, predisposed to support big government solutions to every real or imagined problem, with a false hope, because productive capital accumulation in markets is indispensable both for rising wages for the worker and a growing bounty of quality products for the consumer.

Thomas Piketty’s Capital in the Twenty-First Century might have seemingly come down from the clouds, but its solutions are the same old pie in the sky coercive redistribution that would deliver little but the long term poverty and hardship that proponents of the new found inequality agenda claim to want to vanquish.