Capital in the Twenty-First Century, by Thomas Piketty

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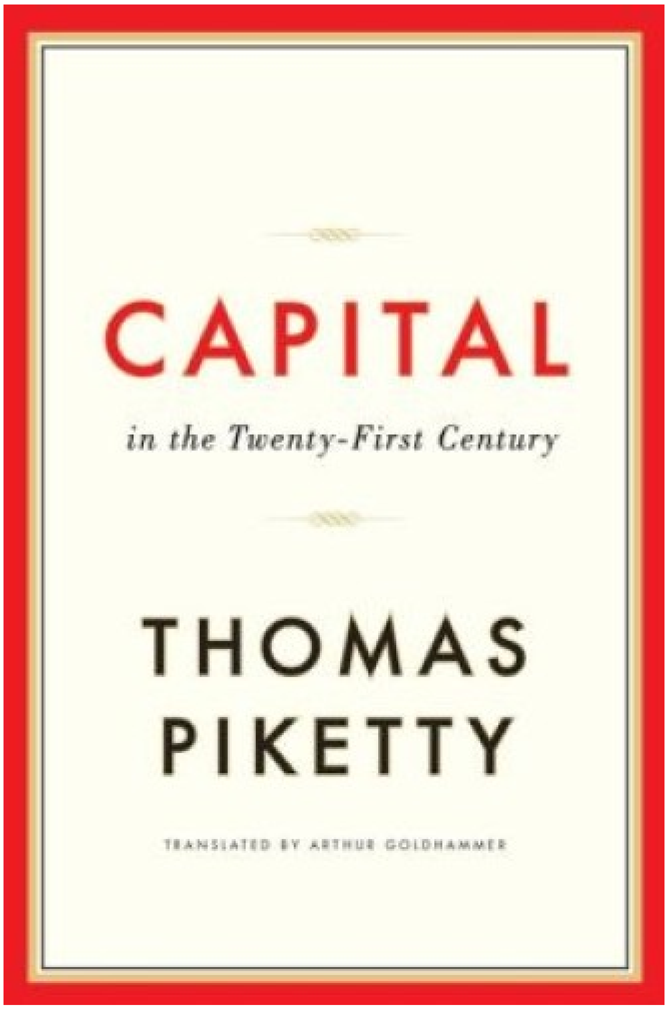
In Review



Capital in the Twenty-First Century

By Thomas Piketty, translated by Arthur Goldhammer
Harvard University Press

Income disparity in the developed world is approaching levels seen only in predemocratic times. Though the spread of educational opportunities has a leveling effect, the income gap is likely to continue to expand—eventually undermining the viability of democratic capitalism.

This stark message from French economist Thomas Piketty has made his extensively documented book a best seller and the object of much scholarly and popular scrutiny. He foresees social unrest arising from increasing income disparities and believes the political dysfunction present in the United States and elsewhere can be attributed to a looming battle between those who seek to protect the income disparity and those who seek to counter it.

The documentation of his thesis is no simple matter. The data presented include charts and graphs that cover the 20th century and in some cases go back to the 18th. Of chief importance is data on the percentage of national income received by the top 10 percent of United States citizens over the past century.

Early in the 20th century, the wealthiest 10 percent received 45 percent of national income. The shocks of the Great Depression and World War II diminished their portion to 35 percent, but beginning in 1980 the wealth of the top decile began to grow. The wealthiest 10 percent now enjoys nearly 50 percent of national wealth, and they are likely to get even richer.

Two concepts are central to Piketty’s analysis of income share. The first concerns the ratio of capital to income. As the ratio rises, capital owners get a larger share of an economy’s income. Consider, for example, the case of an owner of a lawn service who hires six workers to mow lawns with push mowers. The mowers have a total value of $3,000, and the annual revenue from the business is $1,000. If the owner’s annual return on his capital investment of $3,000 is 5 percent, then the owner’s annual revenue from the business will be $150. The six workers share the remaining $850, earning slightly over $140 each.

Consider then what happens if the owner were to purchase a riding mower valued at $6,000. Assuming he still gets a 5 percent return on capital, the owner would get $300 of the $1,000 revenue and the six laborers would have to split $700, or $117 each. The income disparity between the capital owner and the laborer rises as the ratio of capital to income rises. This variable is sometimes referred to as the capital intensity of production.

This story helps illustrates a second key concept. The return on capital to the owner remained at 5 percent as capital intensity increased, even though income growth was zero. If income had grown at 5 percent, to $1,050, the workers would have shared $750 or $124 each. Thus the growth rate of the economy is an important variable in determining differences in income shares.

Putting these two concepts together, Piketty argues that the more capital intensive the economy is and the slower its rate of growth, the bigger the income gap between capital owners and laborers. In the industrial revolution of the late 18th century, small shop production gave way to large factories, significantly expanding the capital intensity. The wealth gap between the rich factory owners and the laborers grew dramatically despite economic growth. In the 20th century, capital depletion from war and economic depression lowered the capital-to-income ratio and reduced income disparities. However, after World War II the capital-to-income ratio again increased significantly and is now reaching new heights.

Clearly many factors complicate the historical data and qualify the key concepts, and Piketty does not ignore them. He considers ways of figuring national income, differences in culture and tax policy, and differences between earned and inherited income. He pays particular attention to the accumulated wealth of the top few percent of the population whose capital return is paid not in rent received on property but in exorbitant corporate salaries. (If the six lawn-care workers in the example above had been fired when the new mower arrived, the one remaining super mower could have gotten a super salary similar to what some CEOs and top managers get in salary and bonuses today.)

Piketty recognizes the necessary role of entrepreneurship and free exchange markets and that these activities generate some legitimate income disparities. However, the way intergenerational fortunes can grow and market prices can be distorted frequently leads to disparities that have no economic justification.

Since the 18th century, market models suggest that remuneration should be based on merit as measured by productivity in a free market. Open competition among actors in labor and product markets is supposed to prevent excess prices and wages. But in some markets, Piketty observes, the producer has monopoly power or possesses information that the average consumer does not have, or may simply be lucky in a volatile economy. When this situation leads to wealth accumulation that compounds across generations, the meritocracy of capitalism evolves into an autocracy similar to that of earlier eras.

Piketty examines university endowments and finds that the return on capital increases as the amount of wealth managed increases. This gives special advantage to the wealthy and widens income disparity. Inflation also alters wealth and, despite its varied impacts, ultimately benefits those with well-managed wealth more than those who have little. These factors, plus the creative legal and accounting structures that the wealthy devise to protect their wealth, raise questions about how free and just markets are in the allocation of wealth.

Given these concerns, the case can be made for leveling the economic playing field. In the latter part of his book Piketty spells out several ways to achieve that goal. “Can we imagine a 21st century in which capitalism will be transcended in a more peaceful and more lasting way, or must we simply await the next crisis or the next war (this time truly global)?” Piketty asks. “Can we imagine political institutions that might regulate today’s global patrimonial capitalism justly as well as efficiently?”

Taxes, transfers, and governmental provision of social goods and services have always been the tools of public policy, but they became increasingly important in the 20th century. From 1870 to 1910, most European countries and the United States took less than 10 percent of national income in taxes. As society became more interdependent and older, more demanding of advanced medical technology, and more conscious of the need for formal education, the public sector’s share of national income increased—to 30 percent in the United States and to 40 or even 55 percent in much of Western Europe. World War II and ongoing national security concerns played a part in that increase, but the social dislocation and the lessons learned in the Depression opened the way for the social state that has become the focus of public policy in recent times.

Piketty’s first proposal is for a global tax on capital. A tax on capital is needed to make the overall tax structure fairer and economically efficient, and a global version of the tax would prevent capital from moving from one country to another for tax reasons. Even without a global tax, a regional tax on capital might work to reduce income disparities by bringing the rate of return on capital closer to the rate of growth in income. Revenue from this tax would provide funds for necessary social programs like health care, education, retirement pensions, and income support. While income transfers are sometimes controversial, they make up a relatively small part of social spending.

In all his policy suggestions, Piketty aims to have the market and the public sector complement each other in such a way that economic efficiency is maintained and public goods are not neglected. Yet his overarching theme—that increased income disparity as a threat to democratic capitalism—remains prominent.

Perhaps the most persuasive policy suggestion in the book is for an 80 percent marginal tax rate on the highest income levels and a more progressive estate tax. Most Americans will be surprised to learn that from 1940 until the 1980s the top marginal income tax rate in the United States was in the 80 percent range for unearned income and nearly as high for wage and salary income.

In Piketty's proposal, only the top 1 percent or top 0.5 percent of earners would face the highest rate. Evidence shows that high tax rates on multimillion-dollar bonuses and super salaries do not undermine work incentives in any significant way. Most likely high tax rates will reduce the demand for such high salaries and free up resources for lower paid workers. Thus the tax would not be a big revenue raiser, but it would reduce income disparities. Because inherited wealth is generally viewed as unearned income, there is less political resistance to high marginal rates on the largest estates. High estate taxes on large estates would also reduce income disparities.

Many Americans will resist calls for a more involved state and for higher marginal tax rates. Piketty, for his part, says little to address concerns about governmental failures and inefficiencies that might complicate the implementation of such policies.

Nevertheless, without some policy changes, it is hard to imagine that countries can avoid the move toward the income disparity that Piketty describes. The emergence of self-driving cars and robotic applications represent the kind of innovation that leads to capital intensive production. His concerns about social unrest cannot be ignored: the movement from personal interdependence to impersonal global interdependence tends to erode trust and voluntary sharing, and wealth disparities are increasingly seen as unmerited and unfair.