Philip Greenspun's Weblog

A posting every day; an interesting idea every three months…

Book review: Piketty’s Capital

philg – June 17, 2014 @ 1:32 pm · Filed under Uncategorized

I’ve written a few posts about the trees inside Thomas Piketty’s verbose tome, Capital in the Twenty-First Century:

- tax people who don’t live in France
- economics and morality
- banks are rich and they don’t get high returns automatically
- can rich people actually get richer past a certain point, or just have more dollars?
- tax and spend to halt climate change
- Piketty, Democracy, and Hugo Chavez
- sample bias leads to Piketty’s conclusion that rich people earn high returns
- better to take money from rich people than to work
- why U.S. GDP is so high
- why Europeans love Socialism
- is income inequality actually higher than 200 years ago?
- can anything be learned from the U.S. housing craze of the 2000s?

Now it is time to look at the forest.

One reason that Piketty’s book deserves attention is that it is a book, not a paper. When a field is pre-paradigmatic, The Structure of Scientific Revolutions (Kuhn) says that progress is made with books, not with journal papers. Is Economics a paradigmatic science like chemistry, biology, or physics? Due to its lack of predictive power, as evidenced by the fact that economists did not predict the Collapse of 2008 nor predict which countries would emerge from that event in the best shape, Econ is pretty plainly pre-paradigmatic (otherwise economists would be as rich as John Paulson). Piketty throws some rocks at his colleagues:

> To put it bluntly, the discipline of economics has yet to get over its childish passion for mathematics and for purely theoretical and often highly ideological speculation, at the expense of historical research and collaboration with the other social sciences. Economists are all too often preoccupied with petty mathematical problems of interest only to themselves. This obsession with mathematics is an easy way of acquiring the appearance of scientificity without having to answer the far more complex questions posed by the world we live in. There is one great advantage to being an academic economist in France: here, economists are not highly respected in the academic and intellectual world or by political and financial elites. Hence they must set aside their contempt for other disciplines and their absurd claim to greater scientific legitimacy, despite the fact that they know almost nothing about anything.

Piketty reminds us continuously that much of the economic growth for which politicians take credit is simply population growth. And also that national borders are substantial barriers to efficient deployment of capital:

> If the rich countries are so flush with savings and capital that there is little reason to build new housing or add new machinery (in which case economists say that the “marginal productivity of capital,” that is, the additional output due to adding one new unit of capital “at the margin,” is very low), it can be collectively efficient to invest some part of domestic savings in poorer countries abroad.

the income of Africans is roughly 5 percent less than the continent’s output (and as high as 10 percent lower in some individual countries). With capital’s share of income at about 30 percent, this means that nearly 20 percent of African capital is owned by foreigners:

According to classical economic theory, this mechanism, based on the free flow of capital and equalization of the marginal productivity of capital at the global level, should lead to convergence of rich and poor countries and an eventual reduction of inequalities through market forces and competition. This optimistic theory has two major defects, however. First, from a strictly logical point of view, the equalization mechanism does not guarantee global convergence of per capita income. At best it can give rise to convergence of per capita output, provided we assume perfect capital mobility and, even more important, total equality of skill levels and human capital across countries—no small assumption. In any case, the possible convergence of output per head does not imply convergence of income per head. After the wealthy countries have invested in their poorer neighbors, they may continue to own them indefinitely, and indeed their share of ownership may grow to massive proportions, so that the per capita national income of the wealthy countries remains permanently greater than that of the poorer countries, which must continue to pay to foreigners a substantial share of what their citizens produce (as African countries have done for decades).

if we look at the historical record, it does not appear that capital mobility has been the primary factor promoting convergence of rich and poor nations. None of the Asian countries that have moved closer to the developed countries of the West in recent years has benefited from large foreign investments, whether it be Japan, South Korea, or Taiwan and more recently China. In essence, all of these countries themselves financed the necessary investments in physical capital and, even more, in human capital, which the latest research holds to be the key to long-term growth.35 Conversely, countries owned by other countries, whether in the colonial period or in Africa today, have been less successful, most notably because they have tended to specialize in areas without much prospect of future development and because they have been subject to chronic political instability.

When a country is largely owned by foreigners, there is a recurrent and almost irrepressible social demand for expropriation. Other political actors respond that investment and development are possible only if existing property rights are unconditionally protected. The country is thus caught in an endless alternation between revolutionary governments (whose success in improving actual living conditions for their citizens is often limited) and governments dedicated to the protection of existing property owners, thereby laying the groundwork for the next revolution or coup. Inequality of capital ownership is already difficult to accept and peacefully maintain within a single national community. Internationally, it is almost impossible to sustain without a colonial type of political domination.

historical experience suggests that the principal mechanism for convergence at the international as well as the domestic level is the diffusion of knowledge. In other words, the poor catch up with

> the rich to the extent that they achieve the same level of technological know-how, skill, and education, not by becoming the property of the wealthy.

In other words, a rich country will continue to invest in its industries, schools, and transportation network even though a much better return on investment is available from investing in a poor country (building a new road to a growing city in Brazil should have more value than repaving an existing road in the U.S.; building high-speed rail in China at a low cost per mile is a much better investment than building high-speed rail in California).

Piketty also notes that the more capital is accumulated the lower the return on capital tends to be, in the same sense that the availability of 1 billion skilled workers in China will tend to lower wages elsewhere or the discovery of natural gas fields will tend to lower the cost of natural gas.

After explaining these factors, however, Piketty pretty much ignores them and posits that returns on capital going forward will be just as good as they have been in the past. And then adds that rich people and organizations will get an even higher return than average schmoes invested in the S&P 500 and other public equities.

Piketty has collected copious data that he says shows that wealth inequality is high right now, comparable to conditions prior to World War I. Critics have said that he is misinterpreting, misquoting, and mistranscribing the data. But let’s suppose that he is right. Piketty argues that this means we are about to enter an era of soaring wealth inequality, the likes of which the world has never seen, in which the rich run away with it all. The top 0.1 percent will taxi their Gulfstream G-650s down Main Street whenever they want to buy a quart of milk. But perhaps Piketty, like Karl Marx, will prove to be a better historian than prophet. The same data could also be interpreted as evidence that capitalism is inherently self-correcting and wealth inequality over 200 or so years has swung between limits despite radically changed circumstances, governments, and technology.

As noted in a previous posting, Piketty’s call to action/arms is based on his prediction that wealth inequality is a runaway process that will lead to a handful of people owning virtually everything on the planet within 100 or 200 years. This prediction rests on the following assumptions:

1. rich people get a better return on their investments than regular investors
2. governments will stop taxing dividend and capital gain income
3. the world economy will grow at best slowly for the next 50-100 years
4. the return on capital will be high
5. rich people won’t consume too much (which means most of their income gets plowed into additional investment)

All of these assumptions are questionable. Regression toward the mean has been one of the safest bets in finance, calling into question Assumption 1. Piketty doesn’t cite any examples of governments that have willingly given up a rich vein of tax revenue. When rates are cut it is typically by politicians seeking to increase actual collections, not in an attempt to shrink revenue. Piketty’s book came out right about the same time that the U.S. added the 3.8% Obamacare tax to investment income, roughly a 25% increase in the tax on capital-based income (depending on one’s tax bracket and whether dividends were “qualified”). Finally, the U.S. actually already has a wealth tax. It is called the capital gains tax not adjusted for inflation. For example, suppose that you bought a stock for $1 million in 2000. The market hasn’t moved much since then, so let’s say that the stock has appreciated only at the official inflation rate. Now it is worth $1.38 million. If you sell it to rebalance your portfolio, you’ll pay federal, state, and Obamacare taxes of about 30%, depending on the state where you live. That’s a $111,400 tax on a non-existent gain, i.e., an 11.4% tax on the wealth that you had in 2000. If we use an inflation rate closer to reality for rich people, instead of the government’s CPI that is based on a lifestyle of consuming Chinese-made DVD players and Costco hot dogs, the stock might have gone up to $1.6 million and the tax would be $180,000 on what is, from the perspective of someone who is buying fancy houses, restaurant meals, hotel rooms, etc., a non-existent gain. That’s an 18% wealth tax.

World economic growth in the 20th century was led by the U.S., a country with poorly educated people according to the PISA test. Since human capital is an important driver of growth, maybe the 21st century will be as strong or stronger now that countries with high PISA scores have market-oriented governments. Thus Assumption 3 may be wrong. If Piketty is right about Assumption 4, i.e., that the return on capital will remain high, he needn’t have wasted his time scribbling out a 700-page book. He could be making literally infinite money in the swap market (since the rest of the folks in finance think that the return on capital going forward will be low).

Assumption 5, that rich people won’t spend, seems questionable as I sit here at the Teterboro airport looking out at a forest of Gulfstreams. It may be hard to imagine that the owner of an Embraer Phenom 300 craves a Gulfstream G-450 or that the owner of a Gulfstream G-450 craves a Gulfstream G-650, but somebody is always buying those fancier planes. As business jets, luxury houses, luxury cars, etc., all depreciate over time, this is spending, not investment. And when rich people bid up the price of houses and/or build new mansions, they end up paying out huge property taxes. Rich people may spend money involuntarily. Most of them will try to live the middle class dream of marriage and children, but this paper by Brinig and Allen predicts that they will be targeted by wealth-seekers and child support profiteers and are likely to face divorce/child support lawsuits, resulting in revenue for the divorce industry (most of whose employees are not super rich) as well as a redistribution of wealth to the person who married or had children for the cash. (Piketty spends a lot of time looking at historical wealth-seeking via marriage but doesn’t try to calculate its effect on wealth in the 21st century.)

One of the deepest problems with Piketty’s work is that he posits a *homo economicus* that behaves the same whether rich or poor. Piketty does not address the carefully researched A Farewell to Alms: A Brief Economic History of the World (Gregory Clark), which attributes economic growth to a growing individual propensity to defer consumption and invest in the future. Rich countries, according to Clark, may be rich because they include a lot of people with a tendency to save rather than to spend. Thus if governments followed through on Piketty’s advice, a huge amount of money would be transferred from people who like to save and invest to people who like to buy SUVs and flat-screen TVs, thus dramatically depressing future economic growth. Piketty doesn’t address the fact that millions of Americans, as soon as they accumulated some wealth in the form of home equity, immediately took out home equity loans and spent that wealth on SUVs, imported oil to fill up the SUVs, imported electronics, trips to Disneyworld, etc. What if we actually need rich people to hold onto our capital so that we don’t spend it?

Another problem is that Piketty proposes radical surgery, starting with a world government to collect wealth taxes, without investigating whether or not some simpler tweaks could work. Piketty is obsessed with taking away money from anyone who earns more than he does or who earns it in a way that he does not respect (e.g., the Qataris who found the cash under their sand dunes). Why not start instead with helping comparatively poor people catch up? Here are some ideas, some taken from my 2009 economic recovery plan for the U.S.:

- make Finland-grade schools available to all young people in every wealthy country (I’m going to write a future posting drawn from The Smartest Kids in the World: And How They Got That Way, but the Finns managed to go from mediocre to excellent mostly by (a) shutting down their teacher colleges, (b) limiting entry to the teaching field to people who had been good students, (c) limiting school systems to education (as opposed to sports facilities), and (d) discouraging teachers and schools from looking into student backgrounds, family disadvantages, etc.)

- liberalizing immigration rules so that well-educated hard-working people can move where their skills have the most value
- reducing government regulation, which tends to favor the rich and established (see GE with their 975-employee tax department) over the poor and starting out
- reduce the incentives for the rich and powerful to lobby politicians by scaling back government involvement in the economy
- cut the military budget, since military spending tends to favor the huge (Elon Musk can make cars, but he probably can't compete with Lockheed or Boeing to sell planes to the Air Force)
- cut government spending in general, since, once again, the government disproportionately buys from big companies owned by rich people
- limit the profitability of child support, as has already been done in most European countries, so that it is more lucrative to go to college and work than to target a high-income person from whom to collect child support (can be $50,000-200,000 or more per year, tax-free, in many U.S. states). People who have regular jobs won't have to feel like chumps because they make less than someone who gets paid to take care (part-time) of his or her own child.
- Singapore-style wage top-up program for people whose skills don't enable them to earn a decent wage in the market (kind of like the Earned Income Tax Credit), instead of a minimum wage that discourages businesses from hiring. Help people to build skills by working so that one day the market may reward them with a high wage.
- break up the cable monopolies instead of letting them merge (see Comcast/Time-Warner) so that Americans can get decent Internet service at a reasonable price; forbid local governments from offering local cable monopolies to cronies
- redirect our education funding from inefficient face-to-face colleges and universities so that more is spent on server-based materials that can be used by people anywhere in the world (compare the value of Wikipedia, which has cost almost nothing, to the subsidized student loans that have sent Americans to crummy colleges for a few years prior to dropping out)

As noted in my economic recovery plan article, the government has been instrumental in allowing corporate managers to loot from shareholders. It could stop prohibiting shareholders from controlling the board (i.e., stop encouraging corporate boards that consist of the CEO's golfing buddies) and also allow shareholders to directly select and choose a pay system for executives (as would not be uncommon in a private company). It seems doubtful that shareholders would voluntarily pay $50-100 million/year to an executive under whose management the company did not outperform benchmarks such as the S&P 500.

What if we did want to cut back on some of the most ridiculously wealthy people building dynasties? We already have an estate tax, though Greg Mankiw points out that raising it will discourage him from working (nytimes). Maybe the estate tax should be adjusted for age at death and also flipped around so that death taxes are paid by those who inherit rather than the person who died. The latter procedure is common in Europe. If you had $10 million and give $500,000 to each of 20 people, the tax is lower than if you give $10 million to one person. This encourages spreading the wealth. How about the age adjustment? Suppose that a person is working hard to accumulate some wealth for her children but she dies from cancer at age 45? Should she face the same tax rate as a person who died at 100 and had a lot of time in retirement to spend? So maybe the tax rate on estates should be much lower for young people who die, about the same for 70-year-olds (see the Bible), and higher for those who die at 90+.

Piketty argues that things are awful, about to get dramatically worse, and we need radical change now. But most of the changes that he proposes wouldn't help those for whom life is truly materially awful, since the wealth transfers he proposes are primarily intra-country. A New York investment banker would be taxed so that an Indiana schoolteacher could drive a new BMW instead of a 5-year-old Honda Accord. A subsistence farmer in Mali wouldn't see any of the dough.

The same data, however, can be used to show that things are actually remarkably good for most people on Planet Earth, with extreme poverty in retreat compared to 50 years ago, and with a lot of demand in most places for any worker who has a good education. Wealth inequality is high, but no higher than it has been at various other times in the past and the idea that 50 families will come to own everything requires accepting a lot of questionable assumptions. Instead of putting our energy into envy we could put our energy into improving our schools so that more people had the chance to achieve their potential.

10 Comments

RobF June 17, 2014 @ 1:47 pm

1

Fantastic write-up. Thank you for the excellent analysis.

Izzie L. June 17, 2014 @ 8:22 pm

2

Saw Piketty on the Charlie Rose program the other day. He tried to project "socialism with a human face" type image – I'm not the bogeyman, he said (in effect). Guys like this are even more dangerous than bearded bomb-throwing anarchists because they seem so harmless and reasonable (but their prescriptions are anything but). For example, he said that he was not actually advocating world-wide taxation, but merely further efforts along the lines that have already been pursued when the US cracked down on Swiss banks that were helping rich Americans to conceal their wealth. FDR was really good at this kind of thing – enacting radical (for the time) reforms while making them seem commonsensical and as American as apple pie. Piketty couldn't pull it off as well, in part because of his comic book French accent which automatically makes him suspicious to Americans.

Glen Raphael June 18, 2014 @ 12:59 am

3

Regarding Piketty's claim "None of the Asian countries that have moved closer to the developed countries of the West in recent years has benefited from large foreign investments, whether it be Japan, South Korea, or Taiwan and more recently China", Scott Sumner says:

"Piketty failed to do his homework on East Asian growth. During its high growth period of roughly 1960 to 1997, South Korea relied very heavily on foreign savings to finance its investment. This allowed South Korea to have higher living standards during its period of rapid growth than China, which severely squeezed consumption in order to generate enough savings for their high-growth model."

(source: http://econlog.econlib.org/archives/2014/06/the_first_funda.html)

Vince June 18, 2014 @ 1:38 pm

4

Piketty has collected copious data that he says shows that wealth inequality is high right now, comparable to conditions prior to World War I. … The same data could also be interpreted as evidence that capitalism is inherently self-correcting and wealth inequality over 200 or so years has swung between limits despite radically changed circumstances, governments, and technology.

I thought that Piketty's claim was that it was the two world wars that reduced inequality during the middle part of the last century. If that's true, I don't see how you could claim that capitalism is self-correcting. And if you're using the term self-correcting, does that mean that you agree that inequality is a problem?

I’m also looking forward to your review of that smartest kids book. I’ve heard that one important factor is that teaching is a high-status profession in Finland and South Korea. It would be interesting to hear if the author discussed that issue at all and if she has any ideas about how the status of the profession could be raised in America. Also, I imagine that it’s quite reasonable to assume that inequality is a lot lower in Finland than the US. A quick glance at Wikipedia showw that South Korean inequality is at a level closer to Scandinavian than to America. This may be a factor as well.

philg June 18, 2014 @ 4:54 pm

5

Vince: Certainly Piketty does highlight war as a factor that caused wealth to be depleted in Europe. And war may not precisely be part of capitalism but it does seem to be part of the human condition. The U.S. was on track to accumulate a huge amount of wealth in the 1990s, for example, and then we squandered $trillions on the wars in Iraq and Afghanistan. The assumption that there won’t be any more wars on Planet Earth does not seem to be a reasonable one.

Is teaching a high-status profession in Finland? Probably, since teachers there are well-educated and do a good job. It seems doubtful that it was a high-status profession when the teachers there were poorly educated and doing a mediocre job (1970s). Anyway, Amanda Ripley does not support the idea that there is a shortcut to prestige (“any ideas about how the status of the profession could be raised in America”). Nor does she dwell on income inequality, except to say that Americans are remarkably good at making excuses for why our schools are so bad. (She cites Poland as an example of a country with a lot of hardship and poverty but without the penchant for making excuses.)

Vince June 18, 2014 @ 8:36 pm

6

From what I’ve read, American inequality has been rising monotonically since the 1970s. In other words, the wars in Iraq and Afghanistan have not reversed the trend.

Our exchange about status of teaching in Finland left me wishing that I had the time to read Amanda Ripley’s book. Fortuantely, she has published an article on the topic just this week. She writes that teaching is more prestigious in Finland because it is more difficult to become a teacher. Higher scores on standardized tests are required, the acceptance rate for teacher training courses is low and so on.

http://www.slate.com/articles/life/education/2014/06/american_schools_need_better_teachers_so_let_s_make_it_harder_to_become.single.html

philg June 18, 2014 @ 9:15 pm

7

Vince: Well… unless you think that the wars in Iraq and Afghanistan were free they had to reduce U.s. wealth. By definition they couldn’t have reduced the wealth of people who didn’t have anything.

Income inequality in the U.S. is complicated by the fact that we have a lot of immigration and, since 1965, a lot more immigration from low-income countries. Look at the charts in http://www.urban.org/url.cfm?ID=900417&renderforprint=1&CFID=90714092&CFTOKEN=76950249&jsessionid=f03078b7e790ae56a6aa3912586160521b79 for example. Would you expect an immigrant from Somalia to have a lot of wealth? If you simply shut down immigration you’d have a much more equal United States.

Izzie L. June 19, 2014 @ 10:42 am

>they had to reduce U.s. wealth. By definition they couldn’t have reduced

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the wealth of people who didn't have anything.

Not necessarily – you can have a negative net worth.

The wars were largely paid for with borrowing that will have to be paid back with future tax revenues (or if we default or inflate the currency, by the bondholders). Since we don't know yet what the future holds, we can't say for sure who is going to pay for these wars. One way (not the right way) is to divide up the national debt and assume that each American owes a proportionate share, in which case there are a lot of people with negative net worth.

Now generally speaking, rich people already pay most of the Federal income and estate tax (as their share of income and wealth has gone up, so has their share of taxes) though on an overall basis the tax structure is less progressive – Social Security and sales taxes have a greater impact (as a % of income) on the less wealthy. But the future tax structure which will be used to actually pay for the wars may be more or less progressive than the one that we already have, though if I had to guess based on political trends (and the continued increase in inequality), it will probably be more.

This is why guys like Piketty are looking for world-wide tax schemes. If you are a billionaire (or a big corporation) it well behooves you to hire an army of tax lawyers to look for ways to put your income in some lower taxed jurisdiction. The IRS vs. a few million upper middle class taxpayers was a fair fight but in the battle of the IRS vs. a handful of clever billionaires and mega-corporations with the smartest tax lawyers that money can buy, you can guess who will win.

Vince

June 19, 2014 @ 2:52 pm

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Another point occurred to me overnight. During the same period that Bush was launching two wars he also pushed through some tax cuts which saved rich Americans quite a bit of money. Some people thought that it was a strange choice for the government to reduce its revenue at the same time that it was starting two costly wars. However, the vice president, a former corporate CEO, declared that deficits don't matter. Deficits rose significantly of course.

A few years later the economy fell into a recession and the deficits and debt increased further.

So it could be said that the two wars were funded thorugh borrowing that has not yet been paid back. Many economists and politicians believe that it will have to be paid back at some point, i.e. the deficits will have to be eliminated. It's not known at this point how that will be accomplished, but some of the ideas flowting around include raising the eligibility age for Social Security and Medicare, reducing anti-poverty programs and intoducing a consumption tax. In other words, it's possible that the burden will be borne to a great degree by low- and middle-income Americans.

Thomas Piketty's Capital

June 29, 2014 @ 2:04 pm

10

[…] I keep stumbling across references to Thomas Piketty's book Capital in the Twenty-First Century. It's been mentioned recently in The Economist, been the subject of a relatively long review by Cory Doctorow on Boing Boing, and it's also been reviewed, in some depth, on Philip Greenspun's Weblog. […]

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