Capital in the Twenty-First Century by Thomas Piketty

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Thomas Piketty, Capital in the Twenty-First Century, (*trans.*) Arthur Goldhammer (Cambridge, MA: Belknap Press, 2014)

An academic journal is not usually the place to find a review of a book that skyrocketed to the top of *The New York Times* best seller list. Yet that is what we have here with Thomas Piketty, a French economist whose English edition of his book, *Capital in the Twenty-First Century*, has stirred both the economics and policymaking worlds. It is not hard to see why. Not only is the book written in a clear and flowing prose, it taps the egalitarian mood that has captured the Western democracies since the recent financial crisis, doing so with strikingly high ambition. Like Karl Marx, whose theories Piketty is revising and updating, the professor of the Paris School of Economics aims at nothing less than to decipher the fundamental laws of capitalism as well as show the way to a more

just society. Despite the impressive assemblage of economic data that Piketty marshals, he fails on both those tasks.

The descriptive task is largely taken up with accounting for the historical shifts in the weight of capital in economic life. Piketty defines capital as any ownable non-human good promising future benefits that can be traded on a market. Falling under this conception are those material items universally classified as capital, such as buildings, plants, machinery, and tools. Also included are titles to these goods, financial assets like stocks, bonds, and mutual funds along with that most basic of financial assets, money of course, held mostly in bank accounts. Added, too, are immaterial goods like patents, copyrights, and trademarks. To keep consistent with national accounting standards, Piketty excludes durable household goods from capital, though he does include residential housing since it offers future services to its owners. Land, distinguished by the classical economists among three factors of production, is instead subsumed under capital on the grounds that it is hopeless to separate the value that nature has by itself conferred on a particular parcel of the earth and that which human effort has added to it. Notably, Piketty goes against the reigning trend of designating the education, skills and training that a person may have acquired as human capital. His reasoning is that human capital cannot be traded (at least not in the societies of our day that prohibit slaveholding) and so is not part of the market. Only work effort can be the subject of market exchanges. The labor traded here constitutes the other factor of production alongside capital bringing about goods and services in the economy.

So far, there's nothing terribly objectionable here. But the analysis quickly starts to break down after Piketty tries to add up the market values of all capital items attributable to a particular country into a single variable called national capital. In turn, this figure is expressed as a ratio to national income, the latter understood as the value of goods and services that a country produces in a given year beyond what is needed to maintain its capital base. He reckons national income to be equal to annual GDP minus 10% for depreciation plus net earnings generated from abroad by domestic individuals and firms. Part of his exploits in data collection is that Piketty manages to provide the capital/income ratio for several leading nations going back centuries, in the case of France and Britain all the way to 1700. By his estimates – which he concedes are fraught with uncertainty -- the capital/income ratio was stable at around seven times national income in both France and Britain throughout the 18th and 19th centuries. Afterwards, with the onset of World War I, the ratio trended downward, reaching a low of just under three in 1950 before rising to five to six times national income. In the United States, reflecting the fact that it was a developing nation during the 19th century, the capital/income ratio increased from three in 1770 to five in 1930. It then descended to slightly under four by 1950 before heading back towards the higher levels seen earlier. What Piketty takes away from all this is that we are in danger of returning to the 19th century universe in which Marx wrote, back when capital supposedly reigned supreme and a rentier class enjoyed a life of leisure financed by the returns on their inherited assets at the same time that workers were forced to make do with the relatively meager wages their labor obtained.

An aggregate figure denoting a society's level of capital can be illuminating. Though capital is heterogeneous – each instance of it having different uses depending on its place in the pattern of production – market prices

offer the best available means of gauging how the present configuration of capital goods is adapted to the future demands of consumers that those goods are ultimately designed to meet. Rising values suggests that the capital stock is well-adapted to the future, whereas decreasing values indicate that forecasting errors have been made that need to be corrected through the liquidation and redeployment of assets. Taking this into account, as well as the fact that market valuations of capital can be distorted by the state's influence over interest rates, an aggregated number can additionally offer a rough proxy of the extent to which capital is deployed in the prevailing modes of production. A well-capitalized economy, after all, means that labor can be rendered more productive so as to afford everyone a higher standard of living.

All that can be gleaned, therefore, from Piketty's description of the capital/income ratio is that Western economies had attained a seemingly high level of development heading into the 20th century. At which point, obviously, a series of unforeseen events, including two global conflagrations and a prolonged depression, greatly weakened the capital structure. So we are now simply back closer to where we were before these catastrophes befell us -- each and every one of them, it needs be said, the result of events originating from the political sphere. That suggests we should consider the actions of governments more than just exogenous shocks in trying to explain major trends in the factors of production. This would be more promising than emphasizing tendencies intrinsic to the market economy allegedly favoring the predominance of capital.

To dissuade us from thinking that we have merely returned to a more normal condition, Piketty warns us that it is likely that capital's ascent will continue to historically unprecedented levels. The theoretical basis for this vision of the future is what Piketty calls the second fundamental law of capitalism:

$$\beta = s/g$$

The symbol β stands for the capital/income ratio, s is the savings rate, while g is the growth rate of national income. The latter is partly a function of population growth, in that more people implies that more goods are produced. As Piketty estimates that population growth will decline in the 21st century, g is expected to fall. Nor does he believe that national income will increase enough per capita to make up for this, as he notes that growth rate has ranged around 1 to 1.5% per year since 1700. He sees little reason to believe this will henceforth defy the historical pattern. A decisive consideration for Piketty is that the return on capital, denoted by r and estimated at 4-5% per annum, has in the past demonstrated a pronounced tendency to be greater than g. Insofar as $r > g$, owners of capital can more readily afford to reinvest a portion of their returns and thereby add to capital at a faster pace than the rest of the economy. Ergo, the capital/income ratio must rise.

We need not get into the question whether the causal relationships implied by the $\beta = s/g$ equation make sense – for example, how exactly is capital inversely related to economic growth? The fundamental mistake that Piketty commits is to treat capital as essentially homogeneous. Only on this assumption could it make sense to hold that, say, a 1% increase in the savings rate is going to lead to some proportionate increase in the capital/income ratio. The fact that the wide diversity of capital goods can be made commensurable by money prices does not mean they cease to encompass that diversity. It remains the case that the value

of an additional capital good will depend on how well it fits in entrepreneurial projects to anticipate prospective consumer wants, and not simply on the amount of money allocated to it. The future of capital cannot be glimpsed through an equation.

The moral part of Piketty's analysis comes to the fore in the second half of the book. Peering within capital, he finds that its ownership has come to be concentrated in fewer and fewer hands since the early 1970s. Compounding this, we are told, is that earnings from labor have also become more unequally distributed. Having now reached the same extreme levels witnessed in the 1920's, a smaller group is left with the wherewithal to accumulate capital from their paycheques. As Piketty hammers these points home with a cavalcade of graphs showing in every which way that inequality is on the rise, the distinct impression is given that the reader is supposed to yield to the onslaught of data and straightaway conclude that we have a grave injustice before us that demands a redistributive solution. Yet "ought" cannot be derived from "is", or at least not in this cursory way. Piketty recognizes this: "Inequality is not necessarily bad in itself: the key question is to decide whether it is justified, whether there are reasons for it" (p.19). Still, though he promises to explore this philosophic issue, he does shockingly little to establish that the inequality he details poses a moral dilemma.

He pursues various tracks. One is to appeal to the authority of the French revolution and, more precisely, the official expression of its principles, the 1791 Declaration of the Rights of Man and of the Citizen. Indeed, Piketty opens his book by invoking the first article of that document stating that "social distinctions can be based only on common utility". When it comes time, however, to delineate what exactly is meant by "common utility", Piketty devotes a mere page to the topic, while turning to another authority, namely John Rawls and his difference principle, according to which inequalities are only justified if they work to the benefit of the less advantaged. Even if we accept Rawls as our moral touchstone, Piketty never shows that the less advantaged have become worse off amid the evolution of capital. The indication he gives is that they own as relatively little capital now as they always have. The less advantaged, in other words, continue to rely almost entirely on their labor, but that buys much more nowadays than it did in decades and centuries past.

Another tack is to invoke democracy. Not only does he argue that it is characterized by an overriding commitment to equality, he invokes the spirit of Jurgen Habermas in trusting to the processes of democratic deliberation to resolve moral questions concerning the economy. Besides the fact that democracy is also devoted to liberty, isn't that regime to be evaluated by a higher criterion and, therefore, properly viewed as the subject, rather than the source, of moral judgment? Finally, Piketty raises the specter of political instability should existing inequalities go unaddressed. Tellingly, this is one point for which he is unable to muster any data. Neither does he take into account the middle class, whose share of capital has augmented in the 20th century, and whose resulting political influence helps forestall tensions between the haves and have-nots, as Aristotle long ago observed.

As a result, Piketty is on shaky moral ground by the time he elaborates his proposal to impose a global capital tax. Nonetheless, the proposal is illuminating in revealing the ultimate logic of the political quest for equality. Realizing that people will try to avoid the tax by shifting their capital to less burdensome locales, Piketty asserts the necessity of a tax

cartel among states in which they agree to share banking and investment information about anyone holding capital assets within their respective jurisdictions . If the social democratic state is to succeed in its drive to further equality, it cannot permit anyone to escape its clutches. That is a far scarier prospect than the inequality that so worries Piketty.