Is *Capital in the Twenty-First Century, Das Kapital* for the twenty-first century?

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1. Introduction

With *Capital in the Twenty-First Century*, (hereafter *Capital*) Thomas Piketty clearly intended to produce a book that will stand as a landmark in the history of economic thought. In his title he alludes to Karl Marx's *Das Kapital* and there is indeed a strong similarity between the two books. Both support the agenda of the political Left and both predict the demise of the capitalist system. A difference is that with Marx this prediction is an unconditional historical necessity, while Piketty believes that the outcome could be avoided through political action. Also, Piketty clearly believes that his work is based on a much more solid scientific foundation both regarding the voluminous data on which his inferences are based, as well as the theory that he uses to interpret it. The overwhelming positive response that the book has elicited from both the public and the economics profession would seem to validate this claim.

From a purely empirical point of view, *Capital* does not contain anything that is essentially new. The data on which the book is based has already been analyzed in a book and several journal articles by Piketty himself as well as in journal articles by associated researchers. This literature has been highly influential and popularized the expressions "the one percent" and "the 99 percent". The sensation caused by *Capital* is undoubtedly due to what is novel in it: the claim to have presented a theory of the evolution of a capitalist economy. Remarkably to my mind, none of the rave reviews of the book that I have seen seriously examines this claim. Many dutifully reproduce $r > g$, the rate of return on capital greater than the growth rate of the economy, but that by itself is no more than an assertion, not a theory. Understanding the reception is in my view at least as important as understanding the book and in this review I treat both aspects.

2. Piketty's theory of the evolution of capitalism

In my review of *Capital* I concentrate on a single issue: Did Piketty present a valid, or at least interesting, theory of the dynamics of a capitalist economy. The question of whether the book deserves the overwhelming praise that it has received depends entirely on how this question is answered. Regarding that theory, Paul Krugman wrote in a much cited review in the *New York Times*:

> …a unified field theory of inequality, one that integrates economic growth, the distribution of income between capital and labor, and the distribution of wealth and income among individuals into a single frame.

"Unified field theory" is the name that Albert Einstein had given to the theory he was seeking during the latter part of his life, in order to unify general relativity theory with quantum mechanics. He never found this theory, nor did he claim to have done so.

Let us look at Piketty's theory. He defines an economy's capital/ income ratio $\beta = K/Y$ and the ratio of the return on capital/total income $\alpha = rK/Y$. With these definitions he formulates his "first fundamental law of capitalism".[1] This and other assumptions are listed in the following table. At the head of each assumption is an indication of what type of statement is being made.

Piketty's theory of the dynamics of capitalism

(1) Identity: "The first fundamental law of capitalism" $\alpha = r\beta$

(2) Empirical statement: In a capitalist economy the rate of return of capital tends to be permanently above the rate of grows of the economy. This is the already famous $r > g$.

(3) Definitional statement: The inequality $r > g$ implies that β will increase.

(4) Empirical statement: The rate of return on capital is relatively stable. This implies that as β increases, so will α. More precisely, it follows from (1) that α will increase if r does not proportionately decline more than β increases.

As Piketty recognizes, (1) is simply a definitional identity. It is rather unusual to refer to an identity as a fundamental law.

The statement (3) is definitional because it is true only if r is defined as the growth rate of capital, i.e. $r = K'/K$. Piketty defines r as "…the average annual rate of return on capital, including profits, dividends, interest, rents, and other income from capital…" He does not mention capital gains or losses as part of his definition. Nor does he mention the fact that much investment in capital markets does not come out of capital returns. Think, for example, of public and private pension funds. Even if these omitted factors were judged to be irrelevant, the statement would still not be true unless *all* of the returns from capital are reinvested, i.e. if there is no consumption out of capital income. But, Piketty himself describes at some length, and with literary allusions, the luxurious style of living of the rentier class. To illustrate the problem with a simple example, assume $= 5\%$, $g = 3\%$ so that $r > g$. Assume further that the recipients of capital income consume 60% of it, leaving 40% to be reinvested. This makes an investment rate of 2%, less than the 3% growth of the economy. This implies a shrinking, not a growing, β.

Strangely, I have found no review that noticed this fundamental flaw in Piketty's theory. The closest that I have found is the following confused remark in (Milanovic 2014):

> …as α increases, not only do capital owners become richer, but, unless they consume the entire return from their capital, more will remain for them to reinvest. (p. 522)

[1] Piketty's "Second Fundamental Law of Capitalism" refers to a possible steady state equilibrium of the economy. It does not have an important function in his book.

As the numerical example above shows, a quite reasonable rate of consumption can invalidate Piketty's analysis.

My conclusion is that Piketty does not have a theory in any formal sense of that term. In the framework of econometrics, he does not have a model that could be evaluated by fitting it to data. That said, the stylized facts which he postulates and projects into the future may very well be valid. They do not depend for their validity on his theory. A secular rise in both α and β remains a possibility. The discussion in reviews by professional economists has in fact concentrated on assessing the plausibility of these stylized facts rather than on Piketty's theory.

The basic data on which Piketty bases his conclusions had already been published and analysed in previous publications by him and associated researchers. They consist of time series for France, The United Kingdom, Germany and the United States, reaching from 1870 to 2010. In all four countries the data exhibit a similar pattern which can be described by distinguishing three periods which I will designate I, II, III. Period I ran from 1870 to the First World War. It was characterized by high levels of β and α, and the inequality $r > g$ was satisfied. Inequality of incomes and wealth was high. It was the time described as *Belle Epoque* in France and as Gilded Age in the United States. Period II goes from the First World War to 1950. During this period β and α decline, r declines and eventually fell below g. The distribution of income and wealth became more equal. Finally, in Period III, which goes from 1950 to 2012, the trends of Period II are reversed, but the levels of Period I have not yet been reached. Piketty extrapolates this trend to the year 2100 and predicts even more extreme values than characterized the Gilded Age (Figure 5.8.).

There is one significant deviation from these stylized facts that has been noted by a number of reviewers, but also by Piketty himself. This is the fact that much wealth in recent decades is the result of the exorbitant rise in the salaries and bonuses of top executives, particularly in the financial sector. In my view, neither Piketty, nor the reviews that I have read, describe this situation correctly. The wealth gained in the financial sector, is best described as the distribution of the loot resulting from the defrauding of the public. The Libor scandal has been described as the biggest fraud in the history of mankind, in terms of the magnitudes involved. As I am writing, a consortium led by the asset managers Blackrock and PIMCO is suing some of the world's largest banks for *250 billion* dollars. None of the top executives involved in this incredible amount of fraud has gone to jail. That is the heart of the problem!

There is a further substantial problem with Piketty's stylized facts. Throughout the history of capitalism huge fortunes have been made by entrepreneurs who created successful enterprises. These fortunes did not result from the return on capital. They are in large measure the result of entrepreneurial talent, risk taking and hard work. This applies also to the fortunes made in information technology in recent decades.

A further very fundamental problem is Piketty's definition of "capital" is that it is an amalgam of real and financial capital. Such a construct has no role in economic theory. The magnitude of this construct fluctuates with the prices of financial assets and is not a measure of the productive capacity of the economy.[2]

[2] Galbraith (2014) deals in some detail with this problem.

Even more difficult than the determination of stylized facts is the identification of the causal factors involved and their projection into the future.. (Milanovic 2014) cites several economic historians who interpret the period under consideration differently from Piketty. Economists who reviewed *Capital* also expressed skepticism regarding Piketty's projection. It is based on the assumption that r remains stable as β increases, which implies near perfect substitutability of capital for labor, an assumption that goes against economic theory and as (Summers, 2014) points out is also contradicted by empirical studies. One can argue however, that as we advance further into the age of information technology and robotics, there may be few barriers to the substitution of machines for humans.

I prefer to adhere to the wisdom of Groucho (not Karl) Marx who remarked that "Predictions are difficult, especially about the future". Nor is this in my opinion the central question. That inequality has risen to levels that are much too high for the health of democratic societies has been widely agreed upon. There is no form of social pathology that is not aggravated by high levels of inequality (Wilkinson und Pickett 2009). Regardless of what we predict for the future, the time to act against inequality is now.

To combat inequality, Piketty would rely entirely on redistribution via taxation. His two proposed measures:

(a) A steep increase of the income tax, rising to 80% at the top.
(b) A comprehensive, progressive, global tax on total wealth.

Regarding (a), it was the policy pursued by governments of the Left (and nearly all governments were of the Left) in the post-WWII era. The policy was largely abandoned because the disadvantages were found to exceed the advantages. The disadvantages are: (1) The policy goes against entrepreneurship and innovation. This is because incentives are reduced and also because it becomes more difficult to amass substantial fortunes that could be invested in business enterprises. (2) Political conflict increases as earners of high incomes use political influence to lower their tax rates, or they look for schemes to avoid paying them altogether. (3) The revenue that can be obtained from "soaking the rich" is way below the expectations of a naïve public.

Regarding (b), Piketty himself calls his proposal "utopian". I believe that a more feasible and desirable alternative is a flat tax on financial assets. It would not require assessing the total wealth of individuals.

I am all in favor of taxing capital. Piketty and most reviewers fear that unless such a tax is levelled globally, capital would flee the locations where it is taxed. I believe that this fear is much exaggerated. The most important element in the choice of location by both firms and individuals is the quality of the location, which has many dimensions. That quality has a price which all residents of the location have to pay. A much bigger problem in my opinion has been the unwillingness of the political classes to close blatant loopholes for tax evasion. The most obvious sign of this is the continuous existence of tax havens, which have no function other than to cheat governments out of the taxes due them.

The political economies, both of nation states, of supra-national organizations such as the European Union, and last but not least our interconnected world economy are badly in need of deep structural reforms. Piketty has no blue print for such fundamental reforms.

3. The reception of *Capital*

I believe that the reception of *Capital* tells us as much, or more, about the current state of our society as does the book itself. A convenient place to study this reception is on Amazon.com. On the page for *Capital* excerpts are given from around 100 editorial reviews of the book. They read like a competition of who can think up the most extravagant superlatives. Following are some examples taken from the beginning of the list:

- "A seminal book on the economic and social evolution of the planet… A masterpiece. 'This book is not only the definitive account of the historical evolution of inequality in advanced economies, it is also a magisterial treatise on capitalism's inherent dynamics.'"
- "Anyone remotely interested in economics needs to read Thomas Piketty's *Capital in the 21st Century*."
- "Defies left and right orthodoxy by arguing that worsening inequality is an inevitable outcome of free market capitalism."
- "Rarely does a book come along… that completely alters the paradigm through which we frame our worldview. Thomas Piketty's magisterial study of the structure of capitalism since the 18th century, *Capital in the 21st Century*, is such a book…"

Of course, this is a biased list. Amazon apparently felt that they could maximize sales by selecting only positive reviews. However, when a list of some 100 reviews can be assembled, many in prominent publications, that praise the appearance of a masterpiece; then there is a collective message, though not necessarily the one the reviewers intended.

Amazon also provides customer reviews, of which at this writing there are 968. These reviews rate the book on a scale of 5 stars (maximum positive), to 1 star (maximum negative). Here is how the book was rated:

5-stars 566, 4-stars 124, 3-stars 51, 2-stars 39, 1-star 188

The overall tendency is clearly very positive. Interestingly, the first two 1 star reviews are warnings that most 1- star reviews are part of a right wing propaganda campaign and written by people who did not buy the book and probably did not read it. My own sampling of 1-star reviews confirmed these warnings.

That Piketty is loved by the Left and detested by the Right is not surprising. However, the exaltation on the Left, which in my view is not even remotely justified by the content of the book, requires an explanation. The Piketty phenomenon reminds me of another one, the euphoria that exploded internationally when Barak Obama campaigned for the presidency against McCain in 2008. Obama had no executive experience whatever and no record of any political achievements. Millions wanted to believe his promises of reforms and bought into his repetitive slogans of "Change", "Hope" and "Yes we can!" Via an innovative internet campaign Obama collected about 100 million dollars for his election. Hopes were high that he would initiate the fundamental economic and financial reforms that, following the financial crisis of 2007-8 were obviously needed.

In a paper that I wrote on the needed financial and economic reforms (Hillinger, 2010) I argued that Obama was unlikely to make any basic reforms. I pointed out that he had received more campaign contributions from industry than McCain. Particularly the finance and health industries, where major regulation was needed, supported him heavily. Surely, the lobbyists for these industries were better informed about his plans than the millions of small donors.

How can the Obama, Piketty phenomena be explained? I believe it is the yearning on the part of the Left, as well as of a wider public tending in that direction, for a Messiah to lead them out of their valley of tears. The Left has not had a dominant intellectual figure since Marx; that dominance vanished along with communism in Russia and China. In the post WWII era intellectual dominance passed first to the conservative philosophers Friedrich Hayek and Karl Popper, augmented later by the neoliberalism of Milton Friedman and the Second Chicago School. There followed the politicians who implemented the neoliberal policies: Ronald Reagan in the United States, Margaret Thatcher in the United Kingdom. A bit later they were followed by converts from the Left: Tony Blair in the UK and Gerhard Schröder in Germany.

Mainstream economics evolved into the neoclassical mold. With its demonstration of the efficiency of (mathematical) competitive markets it provided and additional support for neoliberal politics. Economics went through a number of research paradigms in the post WWII period that shone brightly for a while, produced their Nobel laureates, and then faded. More and more economists are turning to very specific problems, without any new and seemingly important research program in sight. Piketty now offers a vast new research paradigm, and for the first time, at least since Keynes, it is a research program that resonates with the concerns of the Left. No wonder, those prominent economists who sympathize with the Left, like Paul Krugman lauded *Capital* in the highest terms.

4. Conclusions

Piketty is a respected economic historian. The research project on the distribution of income and wealth which he organized has gained him wide recognition even beyond the confines of academia. With *Capital* he is clearly inviting a comparison of himself with Marx. This comparison he fails. Marx Invented concepts such as “class”, “ideology”, “alienation” that have remained central to sociology. I have found no novel concepts or ideas in *Capital* that can be imagined to play such a role.

By treating inequality as an economic problem, Piketty diverts attention away from what it really is – a political problem. His own discussions illustrate the following: Of the three sub-periods of his data set, the two with high or increasing returns to capital and rising inequality were periods with governments friendly to capital. The period with a rising income share going to labor and declining inequality had governments friendly to labor.

My own view is that the trend towards rule by wealthy elites is probably irreversible. Since the rise of the first empires about five thousand years ago rule by narrow elites has been the rule. Wars and revolts changed the elites, but these struggles were between different elites, or factions. Any revolts by the lower classes were brutally put down. Today, most of the world’s populations feel that they have no influence on how their societies evolve and that feeling reflect reality.

The movement to empower the individual began with Greek philosophy, continued with the Enlightenment and led to political and social reforms that empowered ever wider segments of the population. That movement has ground to a halt and is reversing. Largely unnoticed, the elites have done away with the idea of a liberal education that would empower the population by giving them an understanding of social and political realities. Instead, we have what is essentially vocational training.

The Twentieth Century witnessed a unique window of opportunity for the establishment of genuine and lasting democracy. It came about when a large and homogeneous work force, produced by the industrial revolution, was organized into powerful unions. They supplied parties of the Left with money and manpower, equal in power to the money and institutions such as army and police at the command of parties of the Right. As the labor force fragmented and unions declined, the parties of the Left turned to the corporate sector for financial support and became indistinguishable from the parties of the right. The fruitless ideological debates between Left and Right and the failed policies that they are pursuing when in power are destroying democracy itself. I agree with (Wolin, 2008) who predicted that the United States would develop similarly to the late Roman Empire – the symbols of democracy would be maintained, but they would become empty of content. On this path, the United States are only taking the lead. As the elites consolidate their power, the distributions of income and wealth are naturally skewed in their favor; why else would they seek power?

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