CAPITAL IN THE TWENTY-FIRST CENTURY[1]

by Thomas Piketty

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Book Review

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Review

The theme of this book is the inequality of distribution of wealth in the early 21st Century. The book argues that, as the rate of return of capital tends to be higher than the rate of growth of income, capitalism tends to generate an ever-increasing inequality in the distribution of wealth, which radically challenges the meritocratic values on which democratic societies are based. Thus, a correction of this trend is required, and the author proposes a general progressive tax on wealth for this purpose.

The introduction of the book reviews former debates on the theme of the inequality of the distribution of wealth, symbolically polarised in Karl Marx's thesis of ever increasing inequality as an inexorable law of capitalism, and Simon Kuznets' thesis of decreasing inequality as a consequence of consolidation of modern economic growth. Piketty states that most of these debates in the past were based on insufficient data, and tries to overcome this problem by means of the methodology of economic history that is traditionally linked to the so-called 'Annales school'. This calls for an extensive collection of long-term quantitative series of the relevant variables (presented in the technical appendix), and their subsequent analysis, using the available

[1] Le capital au XXIe siècle: Paris, Éditions du Seuil, 2013
English Translation: Harvard, Harvard University Press, 2014

techniques of social sciences, mainly those of economics (which is presented in the book).

The first part of the book deals with the relations between income and capital. It recalls the main facts related to what Simon Kuznets called 'modern economic growth' and also the relation that Piketty calls the 'first fundamental law of capitalism' - the ratio of capital income to total income equals the product of the rate of return of capital (that is to say, the ratio capital income/capital) divided by the capital/income ratio. The topics of inflation and nominal versus real values of capital and income are also considered.

The second part of the book deals with the dynamics of the capital/income ratio. Long-term series show that in highly developed European countries, the ratio remained around 7 from the 18th Century up until the First World War, fell sharply to around 3 in the inter-war period of the 20th Century, remained at that level until the 1970s, and then began to climb to about 6 in the early 21st Century. In the United States of America, the starting point was around 3, and there was a gradual increase to a figure of around 5 on the eve of the First World War, with fluctuations similar to those of Europe ever since. Naturally, the composition of capital changed enormously, from the land-dominated structure of the 18th Century, to the structure dominated by buildings and machinery of today. The topics of private versus public capital, of national versus foreign ownership of capital, and of human capital and slavery are also considered. This analysis leads to the relation that Piketty calls the 'second fundamental law of capitalism': the capital/income ratio tends to equal the ratio of the savings rate (that is to say, the ratio savings/income) to the rate of growth of income.

The following step of the analysis is the functional distribution of income. As might be expected, the evolution of the capital/income ratio is mirrored (on account of the first fundamental law of capitalism, which is presented in the first part of the book) by similar changes of the fraction of total income accruing to capital, which in Europe was rather high (at least around one third) before the First World War, although it fell significantly between the First World War and the 1970s, and has begun to rise again ever since then, whereas the United States experienced traditionally lower levels than in Europe, but it is now at similar levels. The topic of depreciation of capital is also considered. The third part of the book deals with the structure of inequalities. The starting point is inequality of the distribution of income. As a rule, capital income is distributed in a more unequal way than labour income. As might be expected, this means that the higher the fraction of income accruing to capital, the higher the level of inequality in the distribution of income.

It goes without saying that inequality in the distribution of capital is partly a result of inequality in the distribution of inherited capital and partly a result of inequality in the distribution of accumulated capital. As a rule, inherited capital is distributed in a more unequal way than accumulated capital; and inequality in the accumulation of capital increases with inequality in the distribution of income. As the relative importance of inherited capital is usually positively correlated with inequality in the distribution of income, there has been a reinforced trend towards huge levels of inequality in the distribution of wealth in Europe before the First World War, and lower (but growing) levels of inequality in the distribution of wealth in the United States during the same epoch, with a significant reduction of the levels of inequality in the distribution of wealth between the First World War and the 1970s in developed countries, and a trend of rising inequality in the distribution of wealth in recent decades - also in all

developed countries. Piketty stresses that the period of relatively low inequality was characterised by the emergence of a middle class that owned significant patrimonies, which did not disappear with the inversion of the trend during recent decades, but is threatened by the rise of multimillionaires.

The crucial point is that which Piketty calls the ‘third fundamental law of capitalism’: the rate of return of capital tends to exceed the rate of growth of income. As a consequence, saving a relatively smaller fraction of their income allows owners of capital to increase their share of total income and wealth. The fourth part of the book presents the case to preserve a renewed welfare state in the future, and argues that curbing the trend towards increased concentration of wealth is necessary to reach such a goal (and to preserve the very basis of a democratic society). As already explained, Piketty‘s proposal for this scenario is a moderate, but progressive tax on wealth. He discusses the main technical and political problems raised by such a proposal, and concludes that technical problems may be overcome if there is political will to do so, and compares the current resistance to progressive taxation of wealth nowadays with that of progressive taxation of income before the First World War.

The theme of the book is undoubtedly important, and the general methodological proposal is in principle correct; however, several criticisms can be raised regarding both these aspects and the positive analysis carried out. The normative conclusions of the book are, of course, debatable. It is impossible to discuss all the interesting topics here, however a few short comments are presented below.

The main problem concerning the methodology relates to the question of measurement of inequality. Piketty criticises synthetic indicators of inequality, such as the Gini index, as being misleading, and prefers to use figures for the fractions of income and wealth accruing to the richest part of the population, moving rather freely between different top groups (the hundredth richest, thousandth richest, etc.). This may increase suggestiveness, yet it certainly harms systematic appraisal of the facts.

Partly as an inevitable result of such a methodology, the question of poverty is completely absent from the book. As a matter of fact, poverty, that is to say, either absolute poverty, or a relative lack of capacity to reach a socially acceptable minimum level of satisfaction of human needs, is perhaps the worst consequence of extreme inequality. However, as poverty is mainly generated by the existence of low income and wealth, and as Piketty’s attention is concentrated on very high incomes and wealth, poverty and its problems go out of focus, and are barely mentioned in the book.

It is, of course, impossible for a few members of society to indefinitely accumulate wealth at a higher rate than the rate of growth of production and income. Such an evolution would raise the capital/income ratio in a way that would contradict the historical trends identified in the book. Moreover, indefinite accumulation of wealth would tend to reduce the marginal productivity of capital and consequently the rate of return of capital. Piketty does not ignore these facts, but downplays their importance, suggesting that their effect cannot prevent the rate of return of capital exceeding the rate of growth of the economy and thus curb the excessive concentration of wealth in the medium term. In other terms, Piketty forecasts that the social strains caused by the concentration of wealth will become unbearable before those economic mechanisms that restrain such concentration become relevant. However, he does not present any formal or statistical evidence supporting that this is likely to be the case. As a consequence, this topic has been, and is likely to remain, the focus of the main debates concerning this book.

Besides the inevitable doctrinal and political controversies, the main question of relevance raised by the recommendations presented in the book is certainly that of the technical problems raised by the taxation of capital. The most important of these problems relate to the evaluation of individual wealth, taking into account ownership of corporate assets and the deduction of relevant liabilities. The treatment of these difficulties is certainly rather perfunctory in the book.

To sum up: Thomas Piketty wrote a provocative book, chose an even more provocative title, and was rewarded with best-seller status. The book (and especially the technical appendix) is certainly an empirical achievement, adding to former important contributions by the author, and it should be an inspiration for further research on this theme; but its theoretical content is meagre (and, on occasion, even flawed). As a consequence, in the end, the book risks generating more doctrinal heat than scientific light.