Capital Punishment: Why a Global Tax on Wealth Won't End Inequality


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Abstract (summary)

Capital in the Twenty-first Century, by Thomas Piketty, is reviewed.

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Capital Punishment: Why a Global Tax on Wealth Won't End Inequality

Every now and then, the field of economics produces an important book; this is one of them. Thomas Piketty's tome will put capitalist wealth back at the center of public debate, resurrect interest in the subject of wealth distribution, and revolutionize how people view the history of income inequality. On top of that, although the book's prose (translated from the original French) might not qualify as scintillating, any educated person will be able to understand it-which sets the book apart from the vast majority of works by high-level economic theorists.

Piketty is best known for his collaborations during the past decade with his fellow French economist Emmanuel Saez, in which they used historical census data and archival tax records to demonstrate that present levels of income inequality in the United States resemble those of the era before World War II. Their revelations concerning the wealth concentrated among the richest one percent of Americans—and, perhaps even more striking, among the richest 0.1 percent—have provided statistical and intellectual ammunition to the left in recent years, especially during the debates sparked by the 2011 Occupy Wall Street protests and the 2012 U.S. presidential election.

In this book, Piketty keeps his focus on inequality but attempts something grander than a mere diagnosis of capitalism's ill effects. The book presents a general theory of capitalism intended to answer a basic but profoundly important question. As Piketty puts it:

Do the dynamics of private capital accumulation inevitably lead to the concentration of wealth in ever fewer hands, as Karl Marx believed in the nineteenth century? Or do the balancing forces of growth, competition, and technological progress lead in later stages of development to reduced inequality and greater harmony among the classes, as Simon Kuznets thought in the twentieth century?

Although he stops short of embracing Marx's baleful vision, Piketty ultimately lands on the pessimistic end of the spectrum. He believes that in capitalist systems, powerful forces can push at various times toward either equality or inequality and that, therefore, "one should be wary of any economic determinism." But in the end, he concludes that, contrary to the arguments of Kuznets and other mainstream thinkers, "there is no natural, spontaneous process to prevent destabilizing, egalitarian forces from prevailing permanently." To forestall such an outcome, Piketty proposes, among other things, a far-fetched plan for the global taxation of wealth—a call to radically redistribute the fruits of capitalism to ensure the system's survival. This is an unsatisfying conclusion to a groundbreaking work of analysis that is frequently brilliant but flawed, as well.

THE RICH ARE DIFFERENT

Piketty derives much of his analysis from a close examination of an important but generally overlooked driver of economic inequality: in contemporary market economies, the rate of return on investment frequently outstrips the overall growth rate, an imbalance that Piketty renders as \( r > g \). Thanks to the effect of compounding, if that discrepancy persists over time, the wealth held by capitalists increases far more rapidly than other kinds of earnings, eventually outstripping them by a wide margin.

To measure this effect, Piketty focuses on the annual capital-to-income ratio, which expresses the size of a country's total stock of wealth relative to the income generated by its economy in a single year. Capital wealth is generally much larger than yearly national income—in the case of today's developed economies, about five to six times as large.

Piketty expertly narrates the story of how that gap has played a major role in economic history since the dawn of the modern era. The peace and relative stability enjoyed by western Europe during the second half of the nineteenth century allowed for enormous capital accumulation. Unprecedented concentrations of wealth arose, boosting inequality. But two world wars and the Great Depression destroyed capital and interrupted that trend. Those cataclysms led to a new, more egalitarian era, shaped by postwar rebuilding, a strong demand for labor, rapidly growing populations, and technological innovation. The three decades between 1950 and 1980 were truly unusual; the constellation of economic and demographic variables that produced prosperity during that period will probably not be re-created anytime soon.

After 1980, ongoing capital accumulation, slower technological progress, and rising inequality heralded a regression to something akin to the conditions of the nineteenth century. But few notice the resemblance between now and then, especially in one crucial respect: the role of inherited wealth. So many nineteenth-century novelists were obsessed with estates and inheritance-think of Jane Austen, George Eliot, or Charles Dickens—precisely because receiving
wealth from one's parent's was such a common way of prospering during that era. In nineteenth-century France, the flow of inheritances represented about 20-25 percent of national income during a typical year. According to Piketty's calculations, the Western world is headed toward a roughly comparable situation. The relatively thrifty and wealthy baby boomers will soon begin to die off in greater numbers, and inheritance as a source of income disproportionately benefits the families of the very wealthy.

At the core of Piketty's story are the tragic consequences of capitalism's success: peace and a declining population bring notable gains, but they also create a society dominated by wealth and by income from capital. In essence, Piketty presents a novel and somewhat disconcerting way of thinking about how hard it is to avoid growing inequality.

Yet there are flaws in this tale. Although $r > g$ is an elegant and compelling explanation for the persistence and growth of inequality, Piketty is not completely clear on what he means by the rate of return on capital. As Piketty readily admits, there is no single rate of return that everyone enjoys. Sitting on short-term U.S. Treasury bills does not yield much: a bit over one percent historically in inflation-adjusted terms and, at the moment, negative real returns. Equity investments such as stocks, on the other hand, have a historical rate of return of about seven percent. In other words, it is risk taking-a concept mostly missing from this book that pays off.

That fact complicates Piketty's argument. Piketty estimates that the general annual rate of return on capital has averaged between four and five percent (pretax) and is unlikely to deviate too far from this range. But in too many parts of his argument, he seems to assume that investors can reap such returns automatically, with the mere passage of time, rather than as the result of strategic risk taking. A more accurate picture of the rate of return would incorporate risk and take into account the fact that the stock of capital typically grows each year, sudden reversals and retributions are inevitable. Piketty repeatedly serves up the appropriate qualifications and caveats about his model, but his analysis and policy recommendations nevertheless reflect a notion of capital as a growing, homogeneous blob which, at least under peaceful conditions, ends up overshadowing other economic variables.

Furthermore, even if one overlooks Piketty's hazy definition of the rate of return, it is difficult to share his confidence that the rate, however one defines it, is likely to be higher than the growth rate of the economy. Normally, economists think of the rate of return on capital as diminishing as investors accumulate more capital, since the most profitable investment opportunities are taken first. But in Piketty's model, lucrative overseas investments and the growing financial sophistication of the superwealthy keep capital returns permanently high. The more prosaic reality is that most capital stays in its home country and also has a hard time beating randomly selected stocks. For those reasons, the future of capital income looks far less glamorous than Piketty argues.

RICARDO REDUX

Piketty, in a way, has updated the work of the British economist David Ricardo, who, in the early nineteenth century, identified the power of what he termed "rent," which he defined as the income earned from taking advantage of the difference in value between more and less productive lands. In Ricardo's model, rent-the one kind of income that did not suffer from diminishing returns-swallowed up almost everything else, which is why Ricardo feared that landlords would come to dominate the economy.

Of course, since Ricardo's time, the relative economic importance of land has plummeted, and his fear now seems misplaced. During the twentieth century, other economists, such as Friedrich Hayek and the other thinkers who belonged to the so-called Austrian School, understood that it is almost impossible to predict which factors of production will provide the most robust returns, since future economic outcomes will depend on the dynamic and essentially unforeseeable opportunities created by future entrepreneurs. In this sense, Piketty is like a modern-day Ricardo, betting too much on the significance of one asset in the long run: namely, the kind of sophisticated equity capital that the wealthy happen to hold today.

Piketty's concern about inherited wealth also seems misplaced. Far from creating a stagnant class of rentiers, growing capital wealth has allowed for the fairly dynamic circulation of financial elites. Today, the Rockefeller, Carnegie, and Ford family fortunes are quite dispersed, and the benefactors of those estates hardly run the United States, or even rival Bill Gates or Warren Buffett in the financial rankings. Gates' heirs will probably inherit billions, but in all likelihood, their fortunes will also be surpassed by those of future innovators and tycoons, most of whom will not come from millionaire families.

To be sure, outside the realm of the ultra-elites, the United States suffers from unfairness in terms of who gets ahead in life, and a lack of upward mobility profoundly affects the prospects of lower-income Americans. Still, the success of certain immigrant groups suggests that cultural factors play a more significant role in mobility than does the capital-to-income ratio, since the children and grandchildren of immigrants from those groups tend to advance socioeconomically even if their forebears arrived without much in the way of accumulated fortunes.

It is also worth noting that many wealth accumulators never fully diversify their holdings, or even come close to doing so. Gates, for example, still owns a lot of Microsoft stock-perhaps out of a desire for control, or because of a sentimental attachment to the company he co-founded, or maybe just due to excessive optimism. Whatever the reason, over time such concentrations of financial interest hasten the circulation of elites by making it possible for the wealthy to suffer large losses very rapidly.

And in the end, even the most successful companies will someday fall, and the fortunes associated with them will dissipate. In the very long run, the most significant gains will be reaped by institutions that are forward-looking and rational enough to fully diversify. As Piketty discusses, that category includes the major private U.S. universities, and indeed the list of the top schools has not changed much over many decades. Harvard and other elite universities might, in fact, emerge as the true rentiers of the contemporary era: as of 2008, the top 800 U.S. colleges and universities controlled almost $400 billion in assets.

DOING WELL, THEN DOING GOOD

Piketty fears the stasis and sluggishness of the rentier, but what might appear to be static blocks of wealth have done a great deal to boost dynamic productivity. Piketty's own book was published by the Belknap Press imprint of Harvard University Press, which received its initial funding in the form of a 1949 bequest from Walden Phoenix Belknap, Jr., an architect and art historian who inherited a good deal of money from his father, a vice president of Bankers Trust. (The imprint's funds were later supplemented by a grant from Belknap's mother.) And consider Piketty's native France, where the scores of artists who relied on bequests or family support to further their careers included painters such as Corot, Delacroix, Courbet, Manet, Degas, Cézanne, Monet, and Toulouse-Lautrec and writers such as Baudelaire, Flaubert, Verlaine, and Proust, among others.
Notice, too, how many of those names hail from the nineteenth century. Piketty is sympathetically attached to a relatively low capital-to-income ratio. But the nineteenth century, with its high capital-to-income ratios, was in fact one of the most dynamic periods of European history. Stocks of wealth stimulated invention by liberating creators from the immediate demands of the marketplace and allowing them to explore their fancies, enriching generations to come.

Piketty’s focus on the capital-to-income ratio is novel and worthwhile. But his book does not convincingly establish that the ratio is important or revealing enough to serve as the key to understanding significant social change. If wealth keeps on rising relative to income, but wages also go up, most people will be happy. Of course, in the past few decades, median wages have been stagnant in many developed countries, including the United States. But the real issue, then, is wages—not wealth. A high capital-to-income ratio might be one factor depressing wages, but it hardly seems central—and Piketty does not claim, much less show, that it is.

Two other factors have proved much more important: technological changes during the past few decades that have created a globalized labor market that rewards those with technical knowledge and computer skills and competition for low-skilled jobs from labor forces overseas, especially China. Piketty discusses both of these issues, but he puts them to the side rather than front and center.

Of course, income and wealth inequalities have risen in most of the world’s developed nations, and those processes will likely continue and perhaps intensify in the immediate future. But for the world as a whole, economic inequalities have been falling for several decades, mostly thanks to the economic rise of China and India. Growth in those countries has depended in part on policies of economic liberalization, which themselves were inspired and enabled, to a certain extent, by capital accumulation in the West. The relative global peace of the post-war period might have bred inequality in rich countries, but it has also led to reform and economic opportunity in poorer countries. It is no accident that communism was the product of war and civil conflict.

**TAXMAN**

The final chapters of the book, which contain Piketty’s policy recommendations, are more ideological than analytic. In these sections, Piketty’s preconceptions lead to some untenable conclusions. His main proposal is a comprehensive international agreement to establish a progressive tax on individual wealth, defined to include every kind of asset. Piketty concedes that this is a “utopian idea” but also insists that it is the best possible solution to the problem. He hedges a bit on the precise numbers but suggests that wealth below 200,000 euros be taxed at a rate of 0.1 percent, wealth between 200,000 and one million euros at 0.5 percent, wealth between one million and five million euros at 1.0 percent, and wealth above five million euros at 2.0 percent.

Although he recognizes the obvious political infeasibility of such a plan, Piketty has nothing to say about the practical difficulties, distorting effects, and potential for abuse that would inevitably accompany such an instrument government control of the economy. He points to estimates he has previously published in academic papers as evidence that such a confiscatory regime would not harm the labor supply in the short term. But he neglects the fact that in the long run, taxes of that level would surely lower investment in human capital and the creation of new businesses. Nor does he recognize one crucial implication of his own argument about the power of nondiminishing capital returns: if capital is so mobile and dynamic that it can avoid diminishing returns, as Piketty claims, then it will probably also avoid being taxed, which means that the search for tax revenue will have to shift elsewhere, and governments will find that soaking the rich does not really work.

Piketty also ignores other problems that would surely stem from so much wealth redistribution and political control of the economy, and the book suffers from Piketty’s disconnection from practical politics—a condition that might not hinder his standing in the left-wing intellectual circles of Paris but that seems naive when confronted with broader global economic and political realities. In perhaps the most revealing line of the book, the 42-year-old Piketty writes that since the age of 25, he has not left Paris, “except for a few brief trips.” Maybe it is that lack of exposure to conditions and politics elsewhere that allows Piketty to write the following words with a straight face: “Before we can learn to efficiently organize public financing equivalent to two-thirds to three-quarters of national income”—which would be the practical effect of his tax plan—“it would be good to improve the organization and operation of the existing public sector.” It would indeed. But Piketty makes such a massive reform project sound like a mere engineering problem, comparable to setting up a public register of vaccinated children or expanding the dog catcher’s office.

Worse, Piketty fails to grapple with the actual history of the kind of wealth tax he supports, a subject that has been studied in great detail by the economist Barry Eichengreen, among others. Historically, such taxes have been implemented slowly, with a high level of political opposition, and with only modestly successful results in terms of generating revenue, since potentially taxable resources are often stashed in offshore havens or disguised in shell companies and trusts. And when govern- ments have imposed significant wealth taxes quickly—as opposed to, say, the slow evolution of local, consent-based property taxes—those policies have been accompanied by crumbling economies and political instability.

Recent wealth-tax regimes in the European Union offer no exceptions to this general rule. In 2011, Italy introduced a wealth tax on real estate, but Rome retreated the plan after the incumbent government was dealt a major blow in elections last year, partly owing to public dissatisfaction with the tax scheme. Last year, the government of the Republic of Cyprus imposed the equivalent of a tax on bank deposits, only to see the tax contribute to, rather than reverse, the island’s economic struggles.

The simple fact is that large wealth taxes do not mesh well with the norms and practices required by a successful and prosperous capitalist democracy. It is hard to find well-functioning societies based on anything other than strong legal, political, and institutional respect and support for their most successful citizens. There lies the most fundamental problem with Piketty’s policy proposals: the best parts of his book argue that, left unchecked, capital and capitalists inevitably accrue too much power—and yet Piketty seems to believe that governments and politicians are somehow exempt from the same dynamic.

A more sensible and practicable policy agenda for reducing inequality would include calls for establishing more sovereign wealth funds, which Piketty discusses but does not embrace; for limiting the tax deductions that noncharitable nonprofits can claim; for deregulating urban development and loosening zoning laws, which would encourage more housing construction and make it easier and cheaper to live in cities such as San Francisco and, yes, Paris; for offering more opportunity grants for young people; and for improving education. Creating more value in an economy would do more than wealth redistribution to combat the harmful effects of inequality.³

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