BOOKS | MARCH 31, 2014 ISSUE

FORCES OF DIVERGENCE

Is surging inequality endemic to capitalism?

BY JOHN CASSIDY

If current trends continue, Thomas Piketty sees "potentially terrifying" consequences.
ILLUSTRATION BY MICHAEL GILLETTE

In the stately world of academic presses, it isn't often that advance orders and publicity for a book prompt a publisher to push forward its publication date. But that's what Belknap, an imprint of Harvard University Press, did for "Capital in the Twenty-first Century," a sweeping account of rising inequality by the French economist Thomas Piketty. Reviewing the French edition of Piketty's book, which came out last year, Branko Milanovic, a former senior economist at the World Bank, called it "one of the watershed books in economic thinking." *The Economist* said that it could change the way we think about the past two centuries of economic history. Certainly, no economics book in recent years has received this sort of attention. Months before its American publication date, which was switched from April to March, it was already the subject of lively online discussion among economists and other commentators.

Piketty, who teaches at the Paris School of Economics, has spent nearly two decades studying inequality. In 1993, at the age of twenty-two, he moved to the United States to teach at M.I.T. A graduate of the élite École Normale Supérieure, he had recently completed his doctorate, a dense mathematical exploration of the theory behind tax policies. Plenty of bright young European scholars move across the Atlantic, of course, and many of them end up staying. Piketty was not to be one of them. "It was the first time I had set foot in the United States," he recalls in the introduction, "and it felt good to have my work recognized so quickly. Here was a country that knew how to attract immigrants when it wanted to! Yet I also realized quite soon that I wanted to return to France and Europe, which I did when I was twenty-five. Since then, I have not left Paris, except for a few brief trips."

Part of Piketty's motivation in returning home was cultural. His parents are politically engaged Parisians who took part in the 1968 riots. When he was growing up, his intellectual role models were French historians and philosophers of the left, rather than economists. They included members of the Annales school, such as Lucien Febvre and Fernand Braudel, who produced exhaustive analyses of everyday life. Compared with this scholarship, much of the economics that Piketty encountered at M.I.T. seemed arid and pointless. "I did not find the work of U.S. economists entirely convincing," he writes. "To be sure, they were all very intelligent, and I still have many friends from that period of my life. But something strange happened: I was only too aware of the fact that I knew nothing at all about the world's economic problems."

In Paris, he joined the French National Center for Scientific Research, and, later, the Écoles des Hautes Études en Sciences Sociales, where some of his heroes had taught. The main task he set himself was exploring the hills and valleys of income and wealth, a subject that economics had largely neglected. At first, Piketty concentrated on getting the facts down, rather than interpreting them. Using tax records and other data, he studied how income inequality in France had evolved during the twentieth century, and published his findings in a 2001 book. A 2003 paper that he wrote with Emmanuel Saez, a French-born economist at Berkeley, examined income inequality in the United States between 1913 and 1998. It detailed how the share of U.S. national income taken by households at the top of the income distribution had risen sharply during the early decades of the twentieth century, then fallen back during and after the Second World War, only to soar again in the nineteen-eighties and nineties.

With the help of other researchers, including Saez and the British economist Anthony Atkinson, Piketty expanded his work on inequality to other countries, including Britain, China, India, and Japan. The researchers established the World Top Incomes Database, which now covers some thirty countries, among them Malaysia, South Africa, and Uruguay. Piketty and Saez also updated their U.S. figures, showing how the income share of the richest households continued to climb during and after the Great Recession, and how, in 2012, the top one per cent of households took 22.5 per cent of total income, the highest figure since 1928. The empirical work done by Piketty and his colleagues has influenced debates everywhere from Zuccotti Park, the short-lived home of Occupy Wall Street, to the International Monetary Fund and the White House; President Obama has said that tackling inequality and wage stagnation is our foremost challenge.

The question is what's driving the upward trend. Piketty didn't think that economists' standard explanations were convincing, largely because they didn't pay enough attention to capital accumulation—the process of saving, investing, and building wealth which classical economists, such as David Ricardo, Karl Marx, and John Stuart Mill, had emphasized. Piketty defines capital as any asset that generates a monetary return. It encompasses physical capital, such as real estate and factories; intangible capital, such as brands and patents; and financial assets, such as stocks and bonds. In modern economics, the term "capital" has been purged of its ideological fire and is treated as just another "factor of production," which, like labor and land, earns a competitive rate of return based upon its productivity. A popular model of economic growth developed by Robert Solow, one of Piketty's former colleagues at M.I.T., purports to show how the economy progresses along a "balanced growth path," with the shares of national income received by the owners of capital and labor remaining constant over time. This doesn't jibe with modern reality. In the United States, for example, the share of income going to wages and other forms of labor compensation dropped from sixty-eight per cent in 1970 to sixty-two per cent in 2010—a decline of close to a trillion dollars.

Piketty believes that the rise in inequality can't be understood independently of politics. For his new book, he chose a title evoking Marx, but he doesn't think that capitalism is doomed, or that ever-rising inequality is inevitable. There are circumstances, he concedes, in which incomes can converge and the living standards of the masses can increase steadily—as happened in the so-called Golden Age, from 1945 to 1973. But Piketty argues that this state of affairs, which many of us regard as normal, may well have been a historical exception. The "forces of divergence can at any point regain the upper hand, as seems to be happening now, at the beginning of the twenty-first century," he writes. And, if current trends continue, “the consequences for the long-term dynamics of the wealth distribution are potentially terrifying.”

In the nineteen-fifties, the average American chief executive was paid about twenty times as much as the typical employee of his firm. These days, at Fortune 500 companies, the pay ratio between the corner office and the shop floor is more than two hundred to one, and many C.E.O.s do even better. In 2011, Apple’s Tim Cook received three hundred and seventy-eight million dollars in salary, stock, and other benefits, which was sixty-two hundred and fifty-eight times the wage of an average Apple employee. A typical worker at Walmart earns less than twenty-five thousand dollars a year; Michael Duke, the retailer’s former chief executive, was paid more than twenty-three million dollars in 2012. The trend is evident everywhere. According to a recent report by Oxfam, the richest eighty-five people in the world—the likes of Bill Gates, Warren Buffett, and Carlos Slim—own more wealth than the roughly 3.5 billion people who make up the poorest half of the world’s population.

Eventually, Piketty says, we could see the reëmergence of a world familiar to nineteenth-century Europeans; he cites the novels of Austen and Balzac. In this “patrimonial society,” a small group of wealthy rentiers lives lavishly on the fruits of its inherited wealth, and the rest struggle to keep up. For the United States, in particular, this would be a cruel and ironic fate. “The egalitarian pioneer ideal has faded into oblivion,” Piketty writes, “and the New World may be on the verge of becoming the Old Europe of the twenty-first century’s globalized economy.”

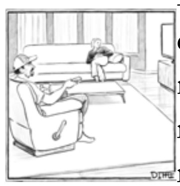
What are the “forces of divergence” that produce enormous riches for some and leave the majority scrabbling to make a decent living? Piketty is clear that there are different factors behind stagnation in the middle and riches at the top. But, during periods of modest economic growth, such as the one that many advanced economies have experienced in recent decades, income tends to shift from labor to capital. Because of enmeshed economic, social, and political pressures, Piketty fears “levels of inequality never before seen.”

To back up his arguments, he provides a trove of data. He and Saez pioneered the construction of simple charts showing the shares of over-all income received by the richest ten per cent, the richest one per cent, and, even, the richest 0.1 per cent. When the data are presented in this way, Piketty notes, it is easy for people to "grasp their position in the contemporary hierarchy (always a useful exercise, particularly when one belongs to the upper centiles of the distribution and tends to forget it, as is often the case with economists)." Anybody who reads the newspaper will be aware that, in the United States, the "one per cent" is taking an ever-larger slice of the economic pie. But did you know that the share of the top income percentile is bigger than it was in South Africa in the nineteen-sixties and about the same as it is in Colombia, another deeply divided society, today? In terms of income generated by work, the level of inequality in the United States is "probably higher than in any other society at any time in the past, anywhere in the world," Piketty writes.

Some people claim that the takeoff at the very top reflects the emergence of a new class of "superstars"—entrepreneurs, entertainers, sports stars, authors, and the like—who have exploited new technologies, such as the Internet, to enlarge their earnings at the expense of others in their field. If this is true, high rates of inequality may reflect a harsh and unalterable reality: outsized spoils are going to go to Roger Federer, James Patterson, and the WhatsApp guys. Piketty rejects this account. The main factor, he insists, is that major companies are giving their top executives outlandish pay packages. His research shows that "supermanagers," rather than "superstars," account for up to seventy per cent of the top 0.1 per cent of the income distribution. (In 2010, you needed to earn at least $1.5 million to qualify for this élite group.) Rising income inequality is largely a corporate phenomenon.

Defenders of big pay packages like to claim that senior managers earn their vast salaries by boosting their firm's profits and stock prices. But Piketty points out how hard it is to measure the contribution (the "marginal productivity") of any one individual in a large corporation. The compensation of top managers is typically set by committees comprising other senior executives who earn comparable amounts. "It is only reasonable to assume that people in a position to set their own salaries have a natural incentive to treat themselves generously, or at the very least to be rather optimistic in gauging their marginal productivity," Piketty writes.

Many C.E.O.s receive a lot of stock and stock options. Over time, they and other rich people earn a lot of money from the capital they have accumulated: it comes in the form of dividends, capital gains, interest payments, profits from private businesses, and rents. Income from capital has always played a key role in capitalism. Piketty claims that its role is growing even larger, and that this helps explain why inequality is rising so fast. Indeed, he argues that modern capitalism has an internal law of motion that leads, not inexorably but generally, toward less equal outcomes. The law is simple. When the rate of return on capital—the annual income it generates divided by its market value—is higher than the economy's growth rate, capital income will tend to rise faster than wages and salaries, which rarely grow faster than G.D.P.



"You wanna watch the Hunting Channel or the Gathering Network?"

If ownership of capital were distributed equally, this wouldn't matter much. We'd all share in the rise in profits and dividends and rents. But in the United States in 2010, for example, the richest ten per cent of households owned seventy per cent of all the country's wealth (a good surrogate for "capital"), and the top one per cent of households owned thirty-five per cent of the wealth. By contrast, the bottom half of households owned just five per cent. When income generated by capital grows rapidly, the richest families benefit disproportionately. Since 2009, corporate profits, dividend payouts, and the stock market have all risen sharply, but wages have barely budged. As a result, according to calculations by Piketty and Saez, almost all of the income growth in the economy between 2010 and 2012—ninety-five per cent of it—accrued to the one per cent.

That's a pretty shocking figure. Piketty calls the tendency for inequality to rise during periods when the rate of return on capital is higher than the economy's rate of growth "the central contradiction of capitalism." Of course, the logic can also run in reverse. If the rate of growth exceeds the rate of return, wages and salaries will grow more rapidly than income from capital, and inequality will fall. That's what happened in much of the twentieth century. The problem, Piketty argues, is that this state of affairs is unlikely to be maintained. "A concatenation of circumstances . . . created a historically unprecedented situation, which lasted for nearly a century," he writes. "All signs are, however, that it is about to end."

How convincing is all this? The standard account of economic development—often attributed to Simon Kuznets, a Harvard economist who popularized it during the nineteen-fifties—has inequality rising during the early stages of industrialization but then falling steadily as incomes converge and over-all living standards rise. Piketty is certainly right to emphasize that there was nothing natural or inevitable about the income compression that occurred in the middle of the twentieth century. It was the product of global conflict and domestic political struggles. In Europe, two World Wars and the progressive tax policies that were needed to finance them did enormous damage to the old estates and great fortunes: many rich people, after paying their income and inheritance taxes, didn't have enough money left to replenish their capital. During the postwar era, inflation ate away at their savings. Meanwhile, labor-friendly laws enabled workers to bargain for higher wages, which raised the proportion of income that labor received. And the task of rebuilding after the wartime destruction made for the rapid expansion of G.D.P. This helped to keep the growth rate above the rate of return on capital, fending off the forces of divergence.

In the United States, the story was less dramatic but broadly similar. The Great Depression wiped out a lot of dynastic wealth, and it also led to a policy revolution. During the nineteen-thirties and forties, Piketty reminds us, Roosevelt raised the top rate of income tax to more than ninety per cent and the tax on large estates to more than seventy per cent. The federal government set minimum wages in many industries, and it encouraged the growth of trade unions. In the decades after the war, it spent heavily on infrastructure, such as interstate highways, which boosted G.D.P. growth. Fearful of spurring public outrage, firms kept the pay of their senior executives in check. Inequality started to rise again only when Margaret Thatcher and Ronald Reagan led a conservative counter-revolution that slashed tax rates on the rich, decimated the unions, and sought to restrain the growth of government expenditures. Politics and income distribution are two sides of the same coin.

Piketty takes some well-aimed shots at economists who seek to obfuscate this reality. "In studying the eighteenth and nineteenth centuries it is possible to think that the evolution of prices and wages, or incomes and wealth, obeys an autonomous economic logic having little or nothing to do with the logic of politics or culture," he writes. "When one studies the twentieth century, however, such an illusion falls apart immediately. A quick glance at the curves describing income and wealth inequality or the capital/income ratio is enough to show that politics is ubiquitous and that economic and political changes are inextricably intertwined and must be studied together."

That's more than mere rhetoric. By insisting that economic laws always take shape through social norms, values, and political choices, Piketty would rescue his discipline from the aridity of abstraction and return it to the richer model of political economy that its best nineteenth-century practitioners pursued. Certainly, it's hard not to be impressed by his history and his methodological assault on theorists who believe that economics can be reduced to a pure science. But is his futurology too pessimistic? The Kuznets curve, mapping inequality over time, is a bell curve: inequality peaks and then declines. Piketty would replace it with a U curve. Are we really condemned to return to the social structure of "Mansfield Park" and "Le Père Goriot"?

A more upbeat possibility is that the rate of G.D.P. growth will approach, or even exceed, the rate of return on capital. If it does, the coming decades could look more like the middle of the twentieth century than like the nineteenth century. To be sure, the past half decade, with many advanced countries mired in slumps, doesn't augur well for an extended period of higher growth. But recessions are cyclical. Over the long term, innovation and increasing productivity are what drive growth. With the rise of the Internet, biotechnology, robots, and other scientific advances, it is at least conceivable that productivity growth will shift to a permanently higher rate, and that G.D.P. will rise with it.

A second possible escape route is for the return on capital to fall, closing the gap with the growth rate. That's what traditional economic theory would predict. As the stock of physical and financial capital gets bigger, the principle of diminishing returns suggests that the rate of profit and interest should decline. Adam Smith and other classical economists said that this would happen; Marx referred to it as "the most important law of political economy." Some economists believe that it is already taking place. For the past decade or so, long-term interest rates have been unusually low, leading Ben Bernanke, the former Fed chairman, to bemoan a "global saving glut." A future of slow growth and ultra-low interest rates wouldn't be a particularly dynamic place, but it wouldn't necessarily involve further increases in inequality.

Another thing that Piketty doesn't adequately consider is the possibility that inequality, in some of its dimensions, is not rising at all. His book largely focusses on Europe and the United States. At the global level, substantial progress has been made in dragging people out of destitution, and extending their lives. In 1981, according to figures from the World Bank, about two in five members of humanity were forced to subsist on roughly a dollar a day. Today, the figure is down to about one in seven. In the early nineteen-fifties, the average life expectancy in developing countries was forty-two years. By 2010, it had risen to sixty-eight years. "Life is better now than at almost any time in history," Angus Deaton, a Princeton economist, wrote in his 2013 book, "The Great Escape: Health, Wealth, and the Origins of Inequality." "More people are richer and fewer people live in dire poverty. Lives are longer and parents no longer routinely watch a quarter of their children die."

That's great news, but it doesn't necessarily mean we're making gains on income inequality. Deaton himself points out that, for all the progress that has been made in poverty reduction and health, the gap between rich and poor countries remains cavernous. "In spite of the achievements of the fast growers, there has been little or no narrowing of income inequality between countries," he wrote. "For every country with a catch-up story there has been a country with a left-behind story."

Still, some people would argue that wage stagnation and rising inequality in the developed world are an acceptable price to pay for the benefits experienced by the worst off. Piketty doesn't really address this question. He glosses over China's success, during the past three decades, in lifting hundreds of millions of people out of extreme poverty. He spends more time detailing the fact that, during that interval, income inequality has been sharply rising in China, and in other developing countries, too. Yet the global picture may complicate his own account of inequality in the developed West. He doesn't seriously consider the argument that globalization—and the rise of nations like China and India—is at once holding down wages and pushing up the profitability of capital, boosting inequality at both ends.

Given that inequality is a worldwide phenomenon, Piketty aptly has a worldwide solution for it: a global tax on wealth combined with higher rates of tax on the largest incomes. How much higher? Referring to work that he has done with Saez and Stefanie Stantcheva, of M.I.T., Piketty reports, "According to our estimates, the optimal top tax rate in the developed countries is probably above eighty per cent." Such a rate applied to incomes greater than five hundred thousand or a million dollars a year "not only would not reduce the growth of the US economy but would in fact distribute the fruits of growth more widely while imposing reasonable limits on economically useless (or even harmful) behavior."

Piketty is referring here to the occasionally destructive activities of Wall Street traders and investment bankers. His new wealth tax would be like an annual property tax, but it would apply to all forms of wealth. Households would be obliged to declare their net worth to the tax authorities, and they would be taxed upon it. Piketty tentatively suggests a levy of one per cent for households with a net worth of between one million and five million dollars; and two per cent for those worth more than five million. "Or one might prefer a much more steeply progressive tax on large fortunes (for example a rate of 5 to 10 percent on assets above one billion euros)," he adds. A wealth tax would force individuals who often manage to avoid other taxes to pay their fair share; and it would generate information about the distribution of wealth, which is currently opaque. "Some people think that the world's billionaires have so much money that it would be enough to tax them at a low rate to solve all the world's problems," Piketty notes. "Others believe that there are so few billionaires that nothing much would come of taxing them more heavily. . . . In any case, truly democratic debate cannot proceed without reliable statistics."

Economists can debate whether such a wealth tax would reduce incentives to invest and innovate, or whether it would be punitive enough to make a real dent in inequality. A more immediate problem is that it isn't going to happen: the nations of the world can't agree on taxing harmful carbon emissions, let alone taxing the capital of their richest and most powerful citizens. Piketty concedes as much. Still, he says, his proposal provides a standard against which to judge other proposals; it points to the need for other useful reforms, such as improving international banking transparency; and it could be introduced in stages. A good place to begin, he thinks, would be a European wealth tax that would replace the property tax, which "in most countries is tantamount to a wealth tax on the propertied middle class." But that may be utopian, too. If the European Union moved ahead with Piketty's proposal, it would produce a rush to tax havens like Switzerland and Luxembourg. Previous efforts to introduce wealth taxes at the national level have run into problems. Spain, for example, adopted a wealth tax in 2012 and abolished it at the start of this year. In Italy, a wealth tax proposed in 2011 never went through. Such difficulties explain why governments still rely on other, admittedly imperfect, tools to tax capital, such as taxes on property, estates, and capital gains.

In the United States, the very idea of a new wealth tax looks like a nonstarter politically, as would the notion of raising the top rate of income tax to eighty per cent. That's not a knock on Piketty, though. The proper role of public intellectuals is to question accepted dogmas, conceive of new methods of analysis, and expand the terms of public debate. "Capital in the Twenty-first Century" does all these things. As with any such grand prognostication, some of it may not withstand the test of time. But Piketty has written a book that nobody interested in a defining issue of our era can afford to ignore. ♦

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