Capital in the Twenty-First Century

by Thomas Piketty

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Many Ways to Read This Opus

Before sitting at my computer to write this review I read several earlier reviews of this work and discovered an important point: readers of reviews of this awfully long book seem to expect a neat summary of its contents to spare them the need to read it, and the reviews invariably adopted a method of meeting this objective. I have to warn readers at the outset that I will abstain from this obligation to provide a neat summary, for two reasons: first, you should read it yourself; and second, I do not want to follow the line of the average reviewer — suddenly waking up to the reality of rising wealth inequality, listening to calls to take arms against social injustice and finally proposing a quixotic policy such as the imposition of a global wealth tax. Reading through all the 950 pages of the original in French I often felt urged by the author to take a stance against this growing inequality. This was a little bit annoying. But my reaction to this may be because I am Japanese.

There are thousands of problems inflicting Japan but rising inequality is probably not the foremost one. Our society has never been torn by endless debate about income redistribution. More urgent problems seem to reside in our growth rate and birth rate which are low and dwindling and because of which Japan and its people may one day cease to exist on this planet. Of course, as Piketty rightly claims, the wealth disparity problem will be aggravated in a low-growth environment so that in hundreds of years from now our descendents will be living in a society controlled by a handful of rich people holding all the wealth. That problem, however, should be handled by our descendents themselves.

I hope that the legacy of this major work will not be a call for a wealth tax but the realization that even today Economics can successfully deal with a big subject in a big volume, and does not need merely to concentrate its whole attention on technical problems. It reminds me of 19th century French society in which the standard fare for literate people was short and complex symbolist poems until Marcel Proust arrived with his seven-volume novel. Just as there are many ways to read Proust's *magnum opus*, so there should be many ways to read Piketty's *Capital.* And you won't ask a reviewer of *À la recherche du temps perdu* to summarize it so that you do not have to read it!

Having started to read it, I was struck by the linearity of his French prose: at times French writers' styles are non-linear, full of nuances and ambiguities. The writing style of Piketty, however, is straightforward and down to earth. No wonder this book translates well into English. Despite that, or because of it, he is unmistakably a French intellectual. The proof of this is his declaration of the book's intent at the beginning. He was disgusted with French scholars of Marxist orientation for their lack of efforts to construct a concrete and viable economic model as a substitute for capitalism. At the same time, through his academic experience in the United States, he felt alien to the milieu of American economists. From his viewpoint they are too preoccupied with mathematical problems, as if the legitimacy of representing the real world with mathematical models can be taken for granted all the time. In particular, he was struck by the uninterest of American economists in real society and real people. As scientists, they are presumed to be immune from the need to take a stance against something and for something. Feeling this disconnection, he decided to return to his native city, Paris.

Real society and real people do not mean for him, however, mere scenery that he can observe from a Parisian café. The society and people described in the great literary works of the 19th century are equally important. Like other reviewers I was deeply impressed with his analysis of Honoré de Balzac's masterpiece, *Pére Goriot*. In this novel, the handsome and ambitious protagonist Rastignac has received audacious advice from Vautrin, a criminal: give up the hope of building a career in the law business and instead marry the daughter of a rich aristocrat! In order to prove the soundness of this advice, Piketty assembles data on the average wealth of the rich segment of society and the average rate of return on capital (around 5%), and finally the average income of higher-ranked magistrates of the period. The result of the calculation proves the point. Even if you succeeded in obtaining the highest ranking and a well-paid position in legal circles, your income would fall far short of the returns from such wealth. This analysis is a *tour de force*. It is not only an interesting economic analysis but also a supreme literary critique, paying tribute to the literary genius of Balzac. This exercise also underlines his claim that the richness of the *Belle Époque* was the richness of the *rentiers* rather than the richness of high wage earners. According to Piketty, European society is once again heading toward this *Belle Époque* situation in the 21st century.

When Logic Is Simple It Is Strong

As I said at the outset, I do not buy all his propositions in this book but the logic behind his main argument is both original and clear-cut. It is based on the probable relationship between two economic variables, interest rate (r) and economic growth rate (g). Piketty claims that we can observe a long-running tendency in which interest rates exceed growth rates — r > g. He says this will lead to widening wealth disparity and thus ultimately to an unsustainable social situation. His argument on this point is brilliant because it turns the conventional argument upside down.

In Economic Theory the situation in which economic growth rates exceed interest rates — g > r — is regarded as paradoxical because it is prone to a speculative bubble: the situation is regarded as "Dynamically Inefficient". In a Dynamically Inefficient Economy a speculative bubble may improve everybody's welfare — this is a point demonstrated by his compatriot Jean Tirole, who received the Nobel Prize in 2014. To grasp this point, consider the following scenario.

You have a succession of generations, starting from generation 0 and going down 1, 2, 3 … Each generation lives two periods: in the first period people work and earn wage income, while in the second period people retire and receive no wage income. Now suppose that in the first period — let's call it period 1 — generation 0, which is already retired in this period, receive T% of the wage income of generation 1, which is still working. An act of charity? Maybe not. Because in the next period (period 2) generation 1, which will have retired, will receive T% of the wage income of generation 2, which will be working. And so on and so forth.

Suppose this whole scheme was invented by generation 0. Then this is nothing but a Ponzi scheme. You receive money from an idiot and the idiot in turn receives money from another idiot, and so on. You may want to say such a swindle should be stopped right away. But the beauty of the scheme is that the first generation, generation 0, which simply receives money, will get rich and every other generation receives a decent interest payment on their initial investments, equaling T% of their wage income, the rate of return on the investment being equal to the growth rate of the wage income. Since there is a tendency for the average wage income to grow at the same rate as the economy, the rate of return on the investment will be g.

If you don't like the swindle, the alternative is to make a normal investment into productive capital. However, the rate of return that you can expect from such a normal investment is r. So if you have g > r, people lose by switching to a normal investment from the swindle — the first generation surely loses because they cannot get money for free any longer and all other generations suffer a decline in the rate of return equaling g–r. Therefore if an economy is making normal investments while g > r such an economy is deemed to be Dynamically Inefficient.

By the way, it may not be appropriate to call the scheme a swindle because this is nothing but the scheme of the pay-as-you-go public pension that most developed countries adopt. In any case, it was a stance of Economic Theory that such a situation is rather abnormal, so that an economy will recover normality once it can reach the situation g > r.

Picketty, however, introduced a different perspective on this inequality. He states that there is a tendency for the wealth disparity in a country to increase if r > g. He bases this claim on the observation that there is a tendency for wealth (financial and residential) to be more unevenly distributed within a country than wage incomes. In particular, in most industrial countries the cohort belonging to the upper 10% in terms of wealth own close to 50% of total wealth. In order to see his point clearly, let us suppose that the richest cohort, the upper 10%, possess the entire wealth of the economy. Let us suppose also r > g and specifically r = 5% and g = 2%. Now suppose that the richest cohort consumes 3% of the interest revenue from their wealth, plowing back the rest to buy more assets. Then both GDP and their wealth will grow by the same rate, namely 2%.

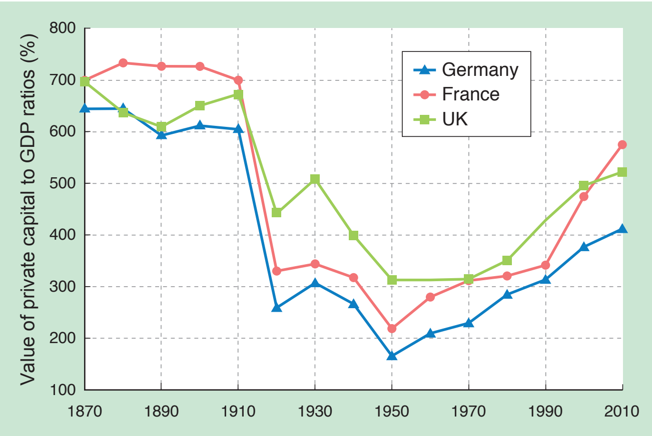
More likely than not, however, being super-rich the richest cohort will need a smaller percentage of the interest revenue to sustain their luxurious lifestyle. If they spend only 1% on consumption, for example, they can plow back 4% to expand their asset holdings. This means that their wealth-to-GDP ratio will keep growing indefinitely. Now the wage income accruing to the entire population is included in GDP. But to the extent that wealth and the returns on the assets accruing to the richest cohort will be getting bigger and bigger compared to GDP, the wealth of the richest cohort will dominate more and more the entire economy — the returns that the richest cohort receive from their wealth will become ever greater with respect to the total wage incomes. This is nothing but a revival of the *Belle Époque* or something worse.

As I have stated, unlike newly industrialized countries which can enjoy high growth rates by simply catching up with the technology leaders, developed countries are experiencing and will experience slower and slower growth rates due to the exhaustion of the new technological frontier, while the rate of return on investments will also drop because of the declining marginal productivity of capital assets — even if you double the number of computers per office worker the production level cannot be doubled — but according to the author the rate of return will decline at more moderate rates. This means that without recourse to such measures as a tax on assets of the richest class society will experience a politically unsustainable widening wealth disparity.

You may challenge his claim that despite the greater accumulation of assets, the decline in the rate of return on assets will still fall short of the decline in the economic growth rate. But the fact remains that historically r tends to be higher than g in most countries and in most

CHART 1

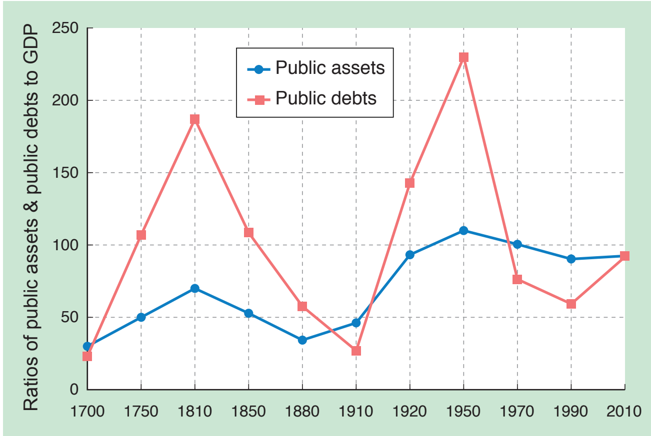
Trends of wealth-to-GDP ratios in 3 European countries, 1870-2010



Source: Piketty, Capital in the 21st Century

CHART 2

Public wealth in UK, 1700-2010



Source: Piketty, Capital in the 21st Century

periods. So I think he has made a valid point. But for my part I am more interested in some other points he makes in the book, so I will concentrate on them.

No Automatic Mechanism to Shape Society

One point that particularly impressed me is the following: all economic variables such as income equality and assets-to-GDP ratio and so on are rather products of political actions than of the natural course of a private economy. The evidence he presented to prove this claim is seen in *Chart 1*, which shows the historical trends of wealth-to-GDP ratios in Germany, France and the United Kingdom. It shows that the wealth-to-GDP ratios in the *Belle-Époque* were high in all three countries but lowered abruptly in the unstable period 1910-1950. Since 1950, however, the ratio has been on the rise and presumably is on the way back to the high plateau of the *Belle-Époque*.

This diagram conveys quite a powerful image for me. I knew that the period 1910-1950 was a turbulent one: it included two great wars, one great depression and German hyperinflation. But I did not know in terms of what economic variables one could capture the main characteristic of the period. After reading Piketty, I now know. The characteristic can be captured by one economic variable alone, the wealth-to-GDP ratio. I can now state the economic meaning of all these devastations — two wars, one great depression and one hyperinflation. Together they have destroyed European wealth.

There are other figures that interest me and are quite relevant in the Japanese context. *Chart 2* and *Chart 3* show public assets and public debts positions (public debt-to-GDP ratios) of two countries, France and the UK. There are several important observations to be made from these diagrams.

1. The public debts of the UK exhibit fluctuations at times rising to 200% or more.

2. The public debts of France exhibit a rising trend but, unlike the UK, there are no discernible fluctuations. At maximum the ratio reaches the level 100 % in 1880.

3. Regarding the public assets of the two countries, there are similar steady upward trends.

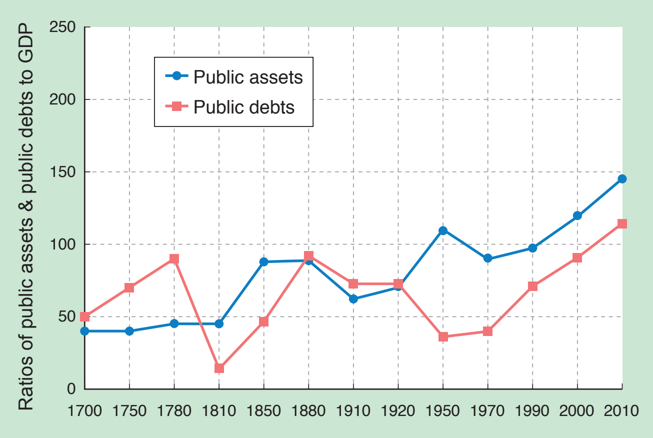
Now the first bulge in UK public debts occurred around 1810. Pushed by the necessity to finance the wars in North America and the Napoleonic wars the ratio soared to 200%. Thereafter it gradually declined to less than 50% by 1910. We know that this swing had a great significance for economic history: the London financial market has grown up from the necessity of financing such a huge volume of government debts and Adam Smith wrote one of the greatest works of all time, *The Wealth of Nations*, in order to attack the colonialists and imperialists who were derailing British government finance from a sustainable course.

There is an important lesson to be learned here for Japan, which currently has a public debt ratio well in excess of 200%. According to Piketty, the British government maintained its budget in balance, and then economic growth took care of the job. It took, however, 100 years for the British government to attain a satisfactory public debt ratio.

I have shown this figure several times to my friends working in Japanese ministries. Naturally their faces darkened on learning these facts. In order to cheer them up, I usually point out another period described in the chart. Quite remarkably, the UK's public debts exceeded 200% in 1950, this time almost reaching 250%. The miracle in this case was that the ratio had already been reduced to less than 100% by 1970, just 20 years later. According to the author, this time around it was high inflation, averaging around 14%, which accomplished the job.

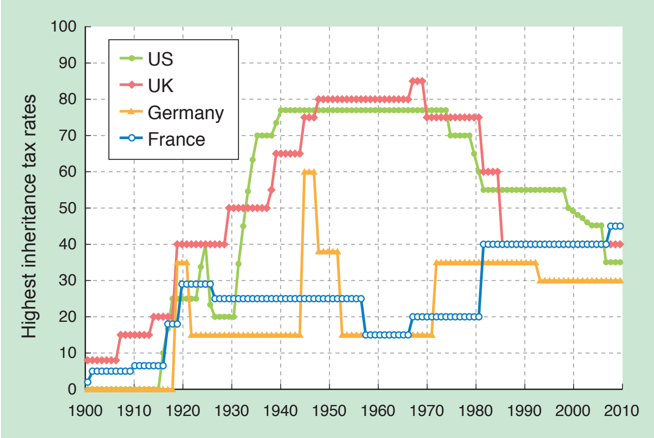
So which scenario would Prime Minister Shinzo Abe prefer? The

CHART 3
Public wealth in France, 1700-2010



Source: Piketty, Capital in the 21st Century

CHART 4
Highest inheritance tax rates of 4 countries, 1900-2013



Source: Piketty, Capital in the 21st Century

1810 scenario or the 1950 one? I hope readers start to understand that historical data are eloquent. They tell quite remarkable and interesting stories. This was actually my way of enjoying Piketty — strolling around the book and stopping at interesting observations and enjoying them. *Chart 4* gives another example. It shows the highest inheritance tax rates of four countries — the US, UK, Germany and France — for quite a long span of time from 1900 to 2013. As it shows, the Anglo-Saxon countries have adopted quite a high level of the highest inheritance rate, reaching 80% for a long time from 1930 to 1980. On the other hand, the highest French inheritance tax rate never reached such a high level until 1960, and at maximum it was 30%.

The figures betray a commonly held misconception: France is an egalitarian society, at times plagued by socialism, whereas Reaganism and Thatcherism are representatives of the *laisser-faire* Anglo-Saxon economic philosophy. They demonstrate that the contrary is true. French government, at its cost, respects the sanctity of private patrimony, whereas the ideals of New Dealers in the US and Bloomsbury philosophy in the UK have controlled the two countries for quite a long period. But what is profoundly interesting is the movement in the highest German inheritance tax rate. It jumped up to 50% around 1946 but just as abruptly in 1950 and later it jumped down. There is no doubt that the jumping up was decided by the Anglo-Saxon occupation authorities, while the jumping down in two droves was decided by a West German government which had regained its autonomy.

We can read the following story from this behavior. Armed with a New Deal and Bloomsbury economic philosophy, the Anglo-American occupation authorities arrived in the Western part of Germany and started to create an egalitarian society in their own image. We had a similar experience in Japan in that period. The US occupation authority, consisting of New Dealers in major part, tried to create a new egalitarian Japan. For this purpose, they broke up the *zaibatsu*, the family network of firms, and liberated agricultural tenants. They succeeded in doing this, so that Japanese society retains an egalitarian character to this day.

Apparently things went quite differently in West Germany. From reading these figures we can understand that Germans did not like egalitarianism imposed from the top, and I think they have a strong disinclination to follow the guidelines of US and UK economic policies to this day. This is why we see strong criticisms of US monetary policies in the major German newspapers, like *Frankfurter Allgemeine* or *Süddeutsche Zeitung*. To be specific, an aggressive monetary easing policy like the quantitative easing implemented by the US Federal Reserve is anathema to them. For their central bank in Frankfurt to adopt this policy would be their worst nightmare.

To conclude, the most important message of Piketty's *Capital* is the one this chart conveys. How wealth is distributed in one country is the outcome of economic policy choices. One can make a society extremely egalitarian if one likes. Behind all these choices lie the culture and intellectual milieu. This is the reason why one has to take a stance, whether for something or against something. **JS**

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