# [What Piketty Leaves Out]

Robert Kuttner, *American Prospect*, 2014

*Despite some losses to financial capital during the Great Depression, the more powerful era of equality in the U.S. began during World War II.*

We have many reasons to be grateful to Thomas Piketty. His justly celebrated book makes it impossible to deny that the concentration of income and wealth are again approaching Gilded Age levels, far beyond what is required for incentive and efficiency. For the past 15 years, Piketty and his colleagues have put together the most comprehensive data set on inequality ever assembled. Now, in *Capital in the Twenty-First Century*, Piketty addresses his subject as a well-educated intellectual, not a myopic number-cruncher. He is as likely to rely on novelists Jane Austen and Honoré de Balzac as on economist Simon Kuznets for insights on social class and inherited wealth, and the tale he tells reconnects the economic with the political. The prose is precise, but this is just not a technical tome, and the fine translation by Arthur Goldhammer renders the text in clear, idiomatic English.

As an economic historian, Piketty begins by rebutting the theorem propounded by Kuznets in the mid-1950s that early capitalism increases inequality as vast fortunes are made and redoubled but that mature capitalism tends to diffuse its benefits. Piketty demonstrates that Kuznets was extrapolating from a special case in the history of capital, and his optimism was premature. Rather, wealth in a capitalist economy tends to concentrate absent exceptional circumstances. More on those exceptions in a moment.

Wealth concentrates for several, mutually reinforcing reasons. First, income on capital tends to grow faster than gross domestic product. If interest, dividends, and other returns to capital ("rents," in classical usage) grow at 5 percent or 6 percent, as they have on average for more than two centuries, but GDP only grows at 1 percent or 2 percent, then the rich get richer and wealth becomes more concentrated over time. Second, the very wealthy are able to realize higher returns than the merely moderately wealthy, because they have access to well-paid advisers, insider knowledge, and techniques such as hedge-fund investing, flash trading, and other plays not available to the ordinary small investor. Third, inequality of wealth and income tend to be mutually reinforcing.

Piketty is also superb at demolishing several conceits that together make up the ideology of conservative economics. The idea that workers and capitalists are paid according to their skills or the marginal value of their product, Piketty says, is valid only as a gross generalization and is more like convenient myth: The labor market "is a social construct based on specific rules and compromises." Education does not solve the problem of rising inequality because education is not its main source. Top executives, he writes, increasingly "have the power to set their own remuneration." In a market system, monopoly profits are supposed to be competed away. But much extreme entrepreneurial wealth that appears to be justly earned is the function of rigged rules and the innovations by others in the public domain. Bill Gates, as Piketty notes, "enjoyed a virtual monopoly in operating systems" and relied on the research of thousands of unsung scientists and engineers.

The only exception to a relentless trend of wealth concentration that dates to at least the French Revolution, Piketty says, is the "historical accident" of the period between 1914 and 1945. But it is here, just when the story gets interesting, that he often loses focus. If something happened during those three decades that altered the tendency of inequality to concentrate, we need to know just what occurred—politically as well as statistically—and how the exceptional period of greater equality might be replicated. Was it inevitable that capitalism should revert to its long-term trend? Or could the right policies grounded in the right politics once again bend it toward a distribution that looked more like that of the postwar boom?

What transpired between 1914 and 1945 that changed the trajectory of inequality? Two world wars, inflation, depression, the rise of fascism, Bolshevism, the New Deal—and the triumph of the democracies at a moment when domestic power alignments made possible more egalitarian policies than usual. All this affected inequality via the loss of a lot of inherited wealth and the weakening of finance as a class. Then in the postwar era, we saw the strengthening of labor and of public institutions dedicated to more generally shared prosperity. Piketty, however, chooses to emphasize one aspect of this history—the destruction of wealth.

When discussing the era of Balzac, Piketty writes like a social and economic historian, but his rendering of what happened since 1914 is more mechanical, in the spirit of a narrow technical economist. An accidental byproduct of war and depression was to destroy capital. Since capital was narrowly held, this accident left capital less concentrated. Full stop. Well, not quite full stop, but there is much more to the history of capitalism's era of greater equality that Piketty downplays or ignores. This simplification is a pity, since Piketty has the intellectual equipment to dig deeper. Happily, he leaves plenty of clues for further digging.

One of the numerous original findings of Piketty's research is to demonstrate that inflation, on average, was almost nonexistent in the century before World War I and that the real returns on capital were stable and predictable, typically about 5 percent. That meant that if you desired an annual income of 50,000 francs, you needed capital of about 1 million francs. Thanks to the gold standard, the world's major currencies—francs, dollars, pounds, and marks—were freely convertible at predictable rates. Most of the French and British upper classes of that era were rentiers—the major part of their income came from capital that they had inherited or perhaps added to via entrepreneurship. Only a minority of the great fortunes were self-made.

Piketty keeps coming back to an emblematic passage from Balzac's novel *Le Père Goriot*, in which Rastignac, an aspiring young lawyer from a poor background, is advised by the cynical Vautrin that a far faster route to affluence and comfort is to win the hand of Mademoiselle Victorine, a rich man's daughter who is neither pretty nor charming but who is worth a million francs. Piketty notes, he could "thus immediately achieve ten times the level of comfort to which he could hope only to aspire years later on a royal prosecutor's salary."

*Le Père Goriot* was written in 1834 and 1835 and set in 1819. The discussion of social class, and the greater rewards of inherited wealth over hard work, would be entirely recognizable to French readers nearly a century later on the eve of the Great War. Despite an industrial revolution that intervened, changing the composition of capital from mostly land to mostly stocks, bonds, industrial plants, and urban real estate, the relationship of capital to rents was remarkably stable. The only thing that changed was that the distribution of income and wealth was even more highly concentrated on the eve of World War I than in Balzac's day. While more fortunes were arguably "earned" in the period after the two wars, the tendency of unearned wealth to cumulate continued. Michael Kinsley, reviewing the original Forbes 400 of the early 1980s in *The New Republic*, calculated that all but 59 of the 400 fortunes were rooted either in inherited wealth, lucky timing, or government contracts. Piketty calculates that only about one-third of the current Forbes fortunes are primarily entrepreneurial.

When World War I broke out, the stable, reliable world of capital was destroyed. As Piketty observes, investments in France's overseas holdings shrunk. Czarist bonds, a favorite of the rentier class, were soon worthless. The massive government borrowing to finance the war triggered inflation, ended the gold standard, and destroyed the secure relationship between capital and income. Something similar happened in Britain. Even more than World War I, World War II demolished both physical capital and financial capital, compressing the wealth distribution as surely as if the wealth had been deliberately confiscated.

This account is true as far as it goes, but there is a great deal more to what occurred, a history that Piketty either misconstrues or downplays. For example, there are immense differences between World War I and World War II and between the dynamics in the U.S. and in Europe, even though the end result of the wars was a brief and exceptional era of greater equality on both sides of the Atlantic.

The period during and after World War I did not just demolish a good deal of capital held by the rich. The 1920s were an era of stupid, deflationary policies and needlessly high unemployment. In their hapless effort to rebuild the prewar rentier economy, the leaders of the interwar period chased one another to collect war debts that could not be repaid and sought to establish prewar values for their currencies. The result was deflation, deepening austerity, and high unemployment. So while World War I may have wiped out a lot of French and British wealth at the top, the aftermath did not benefit the bottom or the middle.

World War I was a different experience for the U.S., which ended the war as the world's dominant industrial and financial power. Our wartime policies briefly imposed surtaxes on the rich (who also profited handsomely from the war boom) but did not lead to destruction of capital. On the contrary, the extreme inequality of the Gilded Age marched onward, right up until it peaked in 1929. While the Great Crash and the Depression did destroy some fortunes, the more significant era for the compression of income and wealth was World War II and its immediate aftermath.

In Europe, World War II was massively destructive of both physical capital and financial wealth. France suffered huge losses and Germany even more, while Britain lost roughly one-fourth of its prewar capital in borrowing to pay for the war. Though Piketty treats the period of 1914-1945 as a single statistical era for purposes of understanding wealth compression in all the major Western nations, the American experience was entirely unlike Europe's. In the U.S., the most interesting years are 1941-1973, not the years bracketed by the two wars as Piketty contends.

Despite some losses to financial capital during the Great Depression, the more powerful era of equality in the U.S. began during World War II. The war was a massive macroeconomic stimulus; it produced full employment, stronger unions, and investment of public capital. The government's wartime policies also repressed private finance in multiple and reinforcing ways, including the Fed's pegging interest rates on Treasury bonds at a maximum of 2.5 percent, marginal tax rates set as high as 94 percent, and an intensification of the anti-speculative financial regulation of the New Deal. All of this did not end with the war. It had a half-life well into the postwar era, until unions were bashed and finance deregulated beginning in the 1970s.

Piketty mentions some of this briefly but doesn't focus on the political dynamics, and he is surprisingly blasé about the role of deliberate policy. "Neither the economic liberalization that began around 1980 nor the state intervention that began in 1945 deserves much praise or blame," he contends. "The most one can say is that state intervention did no harm." But this can't be true. The key difference in the two trajectories of non-recovery after World War I and robust recovery after World War II was in the policies pursued.

The aftermath of the first war led to depression and fascism, while World War II was followed by a boom of widely shared prosperity. In the reconstruction period of 1944-1948, policymakers, cognizant of the mistakes of the Treaty of Versailles and the deflationary 1920s, deliberately created the conditions for domestic full-employment welfare states. There was a great deal more to the anomalous era of shared growth than the shrinkage of inherited wealth, though it's certainly the case that the weakening of financial elites made possible a politics of broad gains for the wage-earning class.

Not surprisingly, Piketty is much better informed on the nuances of French politics and economic history. In France, where the prosperity of the postwar boom is known as the *Trente Glorieuses*—30 glorious years of high growth and full employment—Piketty reports that the wealth distribution was already becoming more unequal again in the late 1940s as capital began recovering its normal place. It was rather high rates of growth, rising real incomes, and the expanding welfare state that made the postwar boom a happy French memory.

"In North America," Piketty writes, "there is no nostalgia for the postwar period because the *Trente Glorieuses* never existed there: per capita output grew at roughly the same 1.5–2 percent rate throughout the period 1820-2012." But this is a non sequitur. A two-century average tells us nothing about particular decades, nor does the average per capita output tell us anything about the wage dispersion. In fact, there is great nostalgia in the U.S. for the postwar boom, and appropriately so, precisely because it was a period of steadily rising wages and job security—a period of both rapid growth and more equal distribution.

He also writes, "The significant compression of income inequality over the course of the 20th century was due entirely to the diminished top income from capital." But that is misleading, too. What really happened is that the temporary weakening of capital, financially and politically, gave progressives and social democrats an opening that they successfully exploited for three decades after the war.

In the U.S., the postwar era (1947-1973) of increasing equality—"The Great Compression," as economist Claudia Goldin famously termed it—is partly a consequence of the top quintile losing its usual capital income. But for most of the population, the main event was the greater equality of labor income of that period. And in some places, such as Sweden, the social democratic era did not require war to destroy wealth at the top (Sweden was neutral during World War II and profited from supplying both sides). In the Swedish case, the dynamic was entirely one of labor gaining power at the expense of capital, both before and after the Great Depression, and using the political process to entrench and redouble its gains.

Another factor that Piketty mostly (and surprisingly) omits is macroeconomics. In the 1930s, the U.S. didn't just under-employ; the economy also underinvested, and the two problems were related. The overhang of the losses from 1929 and the dynamics of what the economist Irving Fisher termed "debt-deflation" left purchasing power depressed and business with too little appetite to invest. Technical breakthroughs like television and commercial aviation were underexploited because of weak aggregate demand. In a classic paper in 1939, when unemployment was still more than 15 percent, the American Keynesian Alvin Hansen estimated the investment shortfall at a then-impressive $2 billion.

Three years later, after Pearl Harbor, in the first six months of 1942, the War Department entered orders of $100 billion—50 times Hansen's radical-sounding number. The economy roared back to life. Much of the investment capital was public. The economy did an end run around flaccid private finance, which had distributive as well as Keynesian consequences. It turned out that you did not need to give private capital exorbitant rewards for the economy to prosper. Indeed, the era of the postwar boom was one in which the rentier class suffered. The real return on capital was negative: Inflation reduced the value of bonds, and the stock market languished. Yet thanks to low capital costs, the economy thrived. Might there be a lesson here?

Appreciating this history is important if we want to get back to something like the distribution of income and wealth obtained during the postwar boom and to avoid the fate that Piketty projects of a society in 2030 as unequal as that of the Gilded Age.

For instance, in the need to invest in a green transition is there a possible strategy analogous to what the U.S. achieved during World War II to use public capital to produce both social gains and a more equal distribution of wages? In his treatment of growth and public capital, Piketty accepts the conventional view that mature economies by definition operate at the frontier of technical possibility. But the new and important book *The Entrepreneurial State* by Mariana Mazzucato suggests that this is not necessarily so. Private capital is myopic when it comes to long-term pursuit of technological breakthroughs. That's why so many of the core innovations of the postwar era were the fruit of patient public capital and public risk-taking. Is it only during depressions and wars that public investment can make up for private market failures, or can public capital increase productivity growth, employment, and expand the technology frontier on an ongoing basis? Piketty commends "new forms of democratic control of capital" (otherwise unspecified) but does not address whether more government support for technical advances could improve the market rate of innovation and productivity growth.

In his final chapters on what is to be done, Piketty supports a more progressive income tax, more egalitarian higher education, and he issues a call for a "social state for the twenty-first century." His breakthrough idea is wishful: a "global tax on capital." Well, sure, that would be great. But if we look harder at the wartime and postwar boom, there may be more plausible strategies within the nearer realm of the politically possible.

A new repression of finance, meaning far tighter regulation of what banks and hedge funds can do, would weaken both the share of the total economic product claimed by rentiers and "super-managers"—and along the way weaken their political power. Clearly, we will need to reduce the sway of capital before we can imagine a global tax on it. The crisis of 2008 was a missed opportunity, but there will be others.

Piketty's book, at various points, is on both sides of the question of whether the more important recent phenomenon is the increasing concentration of capital ownership or a mutation of "meritocratic extremism" that reflects the ability of executives to pay themselves ever-higher salaries disconnected from what they contribute to the economy. It's somewhat misleading to count Wall Street bonuses or corporate mega-salaries as "labor income." These windfalls reflect and reinforce the extreme inequality of our age, as well as the power of capital as a class. Robert Solow put it well, in a respectful review of Piketty's book for *The New Republic*: "It is pretty clear that the class of super-managers belongs socially and politically with the rentiers, not with the larger body of salaried and independent professionals and middle managers."

In a short interview, Piketty says that his discussion of the postwar recovery missed some of the political story, and he regrets understating the important role of unions and shifting power relations. He adds in an e-mail message, "I probably suggest too much that recovery was mostly mechanical, which is excessive. More inclusive institutions and better regulation policies did promote [postwar] mobility and growth." He also says he favors of some kind of green transition, led by public capital.

If we want a more equal society, we need to understand both the institutions and the politics that once undergirded greater equality. Yes, there was the historical accident of two wars and the effect on inherited wealth, but there was also the effort of both statesmen and organizers to maximize the opportunity that history offered.

Right-wing American critics, whose intellectual bankruptcy on the subject of inequality was smoked out by this book, have taken to calling Piketty a "French Marxist" (he is a social democrat). He shares with Marx only a passion for economic history and a quest for an understanding of the deeper dynamics of capitalism. Piketty is just 42. It took Marx three volumes (the last two edited by Engels and published posthumously) to complete *Das Kapital*. We look forward to Piketty's *Capital in the Twenty-First Century*, volume II.