Piketty update: graduate takes on a super star and comes up with a comforting conclusion

The work of Thomas Piketty is back in the spotlight among mainstream economists (see my post, *https://thenextrecession.wordpress.com/2014/04/15/thomas-piketty-and-the-search-for-r/*).

After Piketty's book, Capital in the 21st century, won the business book Oscars as a best seller in America last year, discussion of the book quietened after the American Economics Association's annual jamboree came to an end in January (see my post, *https://thenextrecession.wordpress.com/2015/01/06/assa-part-one-the-rise-in-inequality-and-the-fall-in-piketty/*).

But debate has been revived by the work of 26-year graduate student, Matthew Rognlie. Rognlie's recent work on the Marginal Revolution blog run by neoclassical economist, Tyler Cowen, from George Mason University (*http://marginalrevolution.com/*), has revived discussion of Piketty, prompting the man himself to reply.

Contrary to Piketty's view that the inequality of wealth in the major capitalist economies was set to rise over this century unless action was taken, Rognlie disputes this. Rognlie wrote in his blog post that the French economist's argument *"misses a subtle but absolutely crucial point."* Piketty, he said, might have got the pattern in reverse. Instead of the returns to capital increasing in perpetuity, Rognlie said, they might be poised to decline.

So popular and startling was this post that Rognlie became an instant success and was promoted as a panelist at the esteemed Brookings Institution in Washington, where he presented a paper last weekend before many legendary mainstream economists, including Nobel Prize winner, Robert Solow. It's the first time a mere graduate student has presented a sole-authored paper since 1979 (see *http://www.brookings.edu/~/media/projects/bpea/spring-2015/2015a_rognlie.pdf* and *http://www.mit.edu/~mrognlie/piketty_diminishing_returns.pdf*).

So what are the great revelations of this economics prodigy? Well, Piketty argues that inequality of wealth has risen in the last 30 years because the returns to capital were increasing or at least rising faster than national income. However, Rognlie found the trend to be almost entirely isolated to the housing sector. Yes, some investments with a high level of intellectual property, like computer software, had become extremely valuable in the hands of the wealthy. But some of those assets were unlikely to remain valuable for very long, like a software program that needs to be replaced in a few years with a new version. When adjusting for that depreciation, most of the rest of the increase in capital came in housing, a single sector that, while important, might not shape the entire future of inequality as Piketty assumed.

The second finding was that Piketty overestimates how high the returns to capital would be in the future. For his fears to come true, wealthy people who amass more and more capital would need to keep earning a high return on that capital. But Rognlie's research suggests that the returns to capital will decline over. *"Piketty's story has multiple steps to it. I'm sort of showing that one of the steps does the reverse of what he says it does,"* Rognlie said in an interview. Those findings, he added, suggest *"there doesn't seem to be a big need for panic"* over Piketty's predictions. In other words, forget worsening inequality – it ain't going to happen. This conclusion is music to the ears of mainstream economics, especially its neoclassical wing.

Piketty has responded to Rognlie's criticism. Piketty said *"there is some misunderstanding"* about his book and Rognlie's critique of it. He said he never predicted inequality would *"rise forever"* — only that it could reach *"higher levels than what we have today, and that this is sufficiently important to be concerned."*

He also said Rognlie could be underestimating the ease of substitutions, because technology is making it easier for companies to switch from workers to machines. (As an example, he cited drones potentially replacing delivery

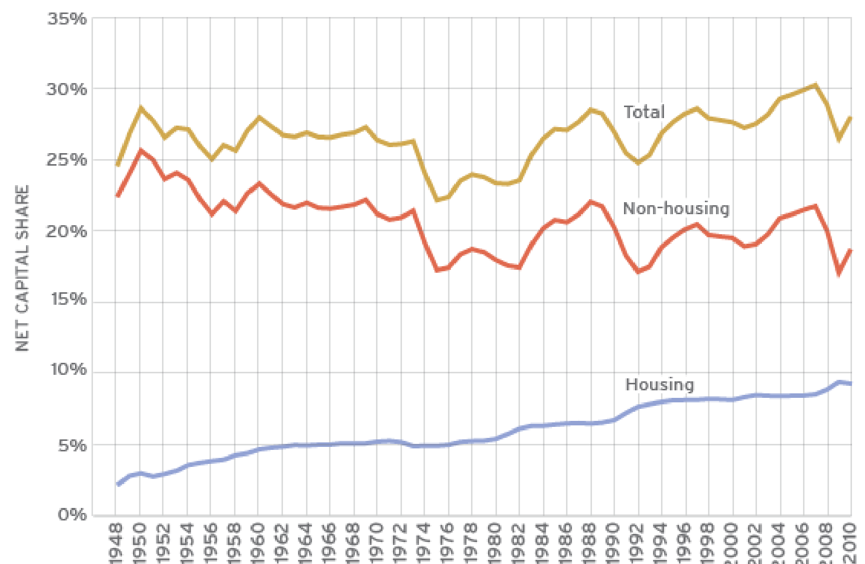
workers at Amazon.) This reduces the demand for labour and increases the income from capital, Piketty would argue.

What can we make of this? Well, the first thing to say is that Rognlie's point that the most of the rise in inequality of wealth in the last 30 years can be explained by the property boom is not new at all. When Piketty's book first came out in France in early 2014, several French economists were quick to latch onto this. In particular, there was a paper by Bonnet, Bono, Chapelle and Wasmer (wp-25-bonnet-et-al-liepp*)*, which concentrates on Piketty's data. The paper points out that valuing housing by movements in property prices rather than in rental equivalents exaggerates the rise in capital share of national income significantly. As I commented in a post at the time, valuing 'housing services' as Piketty does, in some synthetic concoction does not work at all (*https://thenextrecession.wordpress.com/2014/04/30/piketty-in-french-its-worse/*).

And several heterodox economists (see James Galbraith) showed that Piketty's conflation of wealth with capital (in Marx's sense) meant that the rate of return on 'capital' could rise even though there could be a fall in the rate of profit on productive capital. All these points were made by French Marxist economist, Michel Husson and in more detail by Esteban Maito and myself in recent papers (see *https://thenextrecession.wordpress.com/2014/04/23/a-world-rate-of-profit-revisited-with-maito-and-piketty/*). But of course, heterodox economics, let alone Marxist economics, get knows no airing or voice among mainstream economics. Instead, we have to wait for a graduate student at MIT to point these things out to Piketty and his supporters.

What Rognlie shows is that the share of capital income has increased since 1948, but when disaggregated this increase comes entirely from the housing sector: the contribution to net capital income from all other sectors has been zero or slightly negative, as the fall and rise have offset each other.

A rising capital-to-GDP ratio is most likely to result in a fall in capital's share of income, since the net rate of return on capital will fall by an even larger proportion than the capital-to-GDP ratio rises. In other words, or in Marxist ones, the rate of profit on capital excluding property, or more exactly residential housing, has been falling not rising. Rognlie comments on his data for the corporate rate of return: *"The most striking feature of these plots is the general downward trend in r(t): according to this procedure, the required return on capital for the US corporate sector has fallen over the postwar era."* So mainstream economist prodigy Rognlie confirms what we Marxist economists have been arguing for over a decade or more.



The other main criticism by Rognlie of Piketty is his use of gross capital shares and not net of depreciation. Again, this is not a new criticism but has been aired many other economists over the last year. You see, when we deduct the depreciation in the stock of capital over the last 30 years, because of the hi-tech nature of much modern equipment, it becomes obsolete and unprofitable very quickly. So the net stock of capital does not rise that much. This is another way of saying, as Marxist economics does, that the 'moral depreciation' of capital has been high, keeping profitability down. As a result, capitalists turned to speculative investment in financial products and property. So much of the apparent rise in income going to capital is fictitious or unproductive. Sure, that boosts the wealth of the rich, but it does not raise the 'productivity of

capital', namely the rate of return on productive capital; on the contrary.

This is appealing even to Keynesian economists like Brad de Long, who was also a 'discussant' of Rognlie's work and was lavish in his praise. *"It is truly excellent that Matt Rognlie brings well-ordered and insightfully-organized data to these questions."* For de Long, Rognlie has shown that Piketty's explanation for the variation in the post-war capital share of income does not hold up. *"Let me end by strongly endorsing what I take to be Matt Rognlie's bottom line. I take it to be that post-WWII variation in the observed net capital share is not explainable via returns on the underlying assets. Instead, the decomposition attributes most of the variation to pure profits, or markups* (i.e. monopoly rent extraction by the financial sector and property owners – MR comment).

De Long goes on: *"Accumulation and returns play, outside of housing, a distinctly secondary role, if they play any role at all. But it is equally hard to find any role for the race between education and technology, and there should be if we think the factors of production are labour, education skills, and machines. Likewise, variation in income inequality is hard to attribute to wealth ownership or to human capital investment or to differential shifts in rewards to factors like raw labour, experience-skills, education-skills, and machines. Matt thus concludes that: concern about inequality should be shifted away from the split between capital and labour, and toward other aspects of distribution, such as the within-labor distribution of income."*

Yes, behind the Rognlie critique and what appeals to mainstream economists are the conclusions that 1) inequality of wealth will not continue to rise and 2) that the inequality currently evident is not due the capital accumulation or the ownership of property but more to do with inequality of income within the labour force. You see, if the share going to 'capital' has not really risen, then the problem must be one of too highly paid footballers and graduate professionals and too lowly paid shopworkers. So it's not the fault of the capitalist mode of production as such but the distribution of the incomes going the labour.

As David Ruccio has pointed out (*https://rwer.wordpress.com/2015/03/20/the-principal-problem-of-political-economy*/), Rognlie attempts to define away the problem of the class nature of the struggle between capital and labour. By reducing corporate profits by the amount of depreciation of capital, it appears that capital is not really extracting any value from labour.

But that is putting the cart before horse. The first process in the capitalist mode of production is the extraction of surplus value from labour. The second process is the investment of that surplus value in the stock of fixed assets to compete and raise or maintain profitability. As Marx explained, this is where an important contradiction arises; between a rising rate of surplus value and a falling rate of profit. Both Piketty and Rognlie ignore or deny this contradiction. For Piketty, there is a rising share of income going to capital (a rising rate of surplus value) and so no falling rate of profit. For Rognlie, there is no rising rate of surplus value, so there is a falling rate of profit). Both are wrong.

Actually, whether net of depreciation or not, the share of income going to capital (the rate of surplus value if you like) in the G7 economies has been rising, if you include housing. On a net basis it has risen since the mid-1970s, even if the share is not much higher than in the mid-1960s. And yet the rate of profit on productive capital has fallen in G7 economies since 1950 (see the joint paper Carchedi and Roberts The long roots of the present crisis and see Maito, Maito__Esteban_Ezequiel_-_Piketty_against_Piketty_(on_evaluation_on_Review_of_Political_Economy)-libre).

So the Rognlie papers have not really brought up anything new in the debate about Piketty's work and his conclusions. There is no dispute that the inequality of wealth and income in the main capitalist economies had risen to 19th century heights by the end of the 20th century. Rognlie merely follows previous work by heterodox and Marxist economists to show that this is mainly due to the explosion in the value of housing in the last 30 years. So Piketty's 'fundamental laws of capitalism' that Piketty contrasts to that of Marx, namely that the rate of return on capital is and will be higher than the growth of income; and that savings rates will rise to benefit the owners of 'wealth', are not correct explanations of rising inequality (see my review of Piketty and the search for r, upcoming in Historical Materialism and my Essays on Inequality).

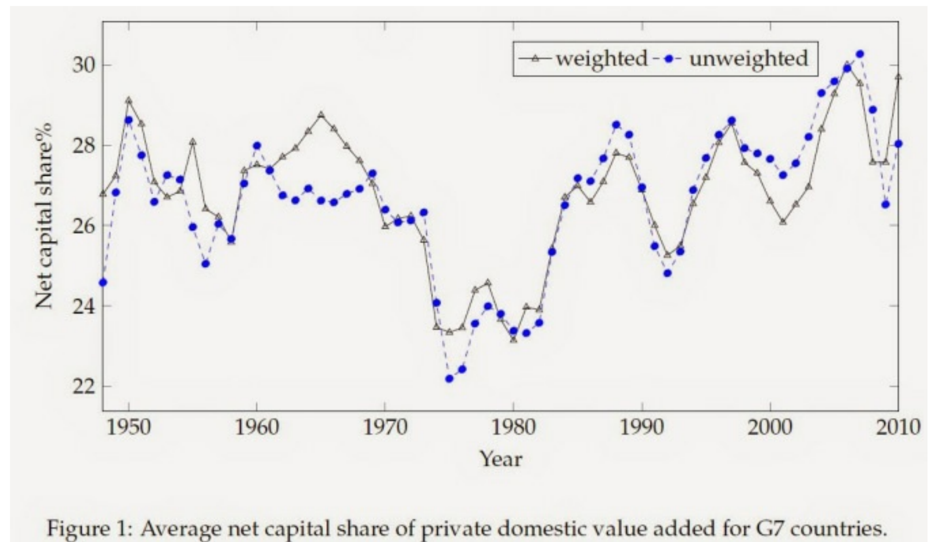
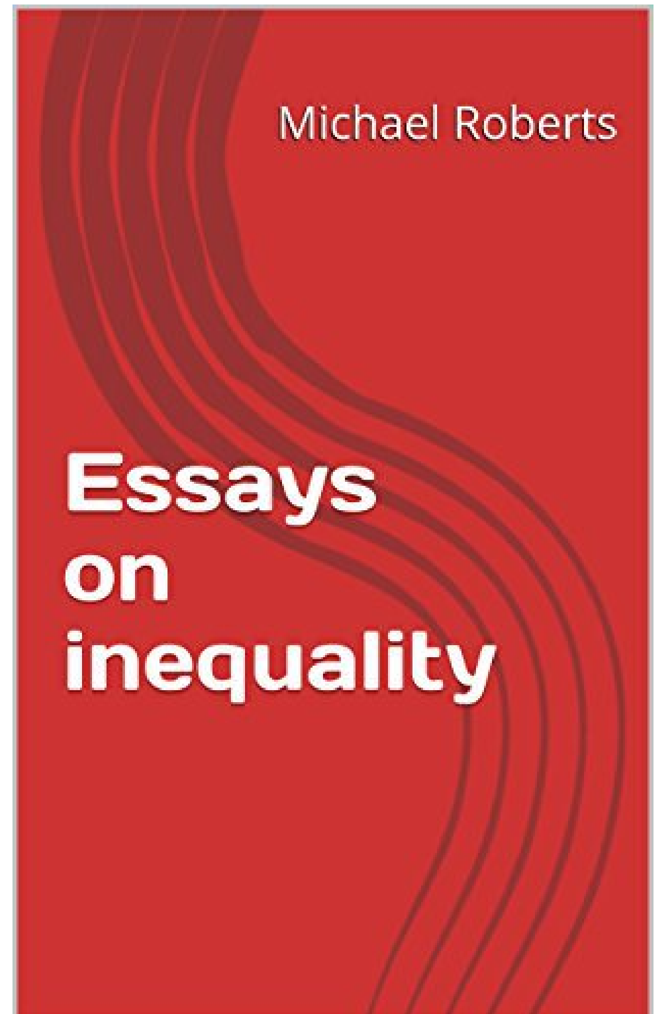


Figure 1: Average net capital share of private domestic value added for G7 countries.

Essays on inequality (Essays on modern economies Book 1)



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What Rognlie adds for the benefit of mainstream economics is the conclusion that this means that inequality of wealth and income could fall from hereon if the bubble in housing and financial products does not resurface and that the real cause of inequality is within workers' incomes and not between capital and labour. It is a comforting and well-lauded conclusion for the ruling consensus.

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