A review on ‘Capital in the 21\textsuperscript{th} Century’

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Abstract: This paper is a brief review on the book ‘Capital in the Twenty-First Century’ by the French scholar Thomas Piketty. The book has started a new debate about inequality and capital taxation in Europe. It provides interesting empirical facts and develops a theory of the functioning of capitalist economies. However, I personally think the book is less convincing than recognized in the public debate. The demonstrated theory of economic growth in the book is elusive and lacks a psychological and behavioral underpinning. In fact, I do think that the increasing inequality and economic divergence are caused by capitalism but the psychological and behavioral aspects of humans are of similar or greater significance. Therefore, Piketty’s argument does not stimulate an open and scientifically founded debate in all aspects.

Keywords: Inequality, Poverty, Behavioral Economics, Capital Taxation, Eurozone Crisis

1. Introduction

The book ‘Capital In The Twenty-First Century’ by Thomas Piketty is recognized as one of the big surprises in the recent book market. The book has nearly 700 pages, but despite its length and bulky social and economic topic, it is discussed in virtually all mainstream newspapers and TV-shows in Europe. Across the Atlantic, the book has been hardly noted, although it is available in English and was reviewed by TIME Magazine [1]. So far, it sells mainly on the east coast, where America is similar to Europe.

One reason might be that the author, a French professor is counted as slightly left-wing. Nevertheless, \textit{Capital in the Twenty-First Century} is a best-seller in many countries and at Amazon.com. The huge public interest, measured by Google Trends in Figure 1, demonstrates that topics such as rising income inequalities and the unsoundness of capitalism have the potential to influence modern societies in the wake of the financial crisis.

In the next section, I describe the key findings and discuss the most important implications. Section 3, concludes the paper.

2. Results and Discussion

The main theme of the book is the study of different forms of capital, income and wealth inequalities over time and across countries [2]. Piketty attempts to explain the evolution of the upper, the middle and lower class. It is needless to say that the definition of income classes can be criticized. Of course, this is not the main point because definitions are neither right nor wrong – they just have to be applicable. The definition used by Piketty is definitely practicable to support his argument in growing inequalities.

The book asserts that the capital and wealth inequality is less distinct today than 100 years ago (before World War I), but nowadays the inequality level is reverting to that in earlier times. He demonstrates that the main driver of inequality is a simple economic relationship between the real rate of return (r) and the output growth rate (g). Provided that $r > g$, Piketty argues that the concentration of capital significantly increases over time. Moreover, he confirms that the mitigated inequality level in the 1950s is ‘largely a consequence of accidental events (the shocks of 1914-1945, [the two World Wars]) and specific institutions such as taxation of capital and its income’ (Piketty, p. 376, [3]). This message is undisputed in economics.

But what is really new in the book and what has triggered this enormous interest? And even more importantly, can we learn anything from it? The following paper is not a standard book review. It is a book review that emphasizes the psychological and behavioral aspects the book is lacking.

Hence, I intend to focus on the lessons from the book for the ‘Eurozone Crisis’.

2.1. Popularity of the Book

First of all, Piketty’s book is based on a scientific approach and uses unique time series over two centuries. Except from his normative statements in Part IV of the book, the book is written in an unbiased manner. Moreover, Piketty is quite frank about data limitations and potential errors. There are many interesting findings. The long-run empirical time series are impressive, providing interesting insights on, for example, the limits of the life-cycle saving hypotheses of Modigliani-Miller (chapter 11), and thus the importance of psychological and behavioral elements in economics. Moreover, he demonstrates the limited validity of the productivity law (chapter 6 & 9) in terms of wage payments over the income distribution.

Obviously, the second secret of Piketty’s success is that he avoids sophisticated mathematical equations or models. In my opinion, however, it is a weakness of the book because it lacks the theoretical underpinning of empirical facts. Consequently, Piketty’s forecasts of future economic developments are nothing else than reading a crystal ball. Moreover, he mainly concentrates on standard theories developed by Robert Solow in the 1950s, neglecting what endogenous growth theory is taking into account or the new developments in behavioral economics. In addition, he does not discuss behavioral macroeconomics [4] with heterogeneous agents or the theory of new economic geography [5,6]. This is even more surprising because Piketty criticizes the ‘so-called representative agent model’ in economic theory several times (p. 135ff, [3]). His critique is even less convincing because Piketty himself often uses average numbers for proving propositions in the book. Finally, Chapter 16 discussing ‘The Question of the Public Debt’ is definitely the weakest part of the book because it is mainly unscientific and somewhat ‘general store’ like. He is neither an expert in monetary economics nor macroeconomics, and thus any of his ideas emphasizing to counteract the Eurozone crisis is short-sighted, such as the unfledged idea of debt mutualisation. If he had studied his proposal with the same rigor as he did on the global tax on capital, he would have immediately realized that it would harm the poor in favor of the rich, which is contrary to the primary message of the book. Unfortunately, Piketty failed to understand that ‘structural’ policy failures cannot be resolved by unlimited liquidity from governments or central banks rather by reforms [7].

The third secret of the book is the timing of the publication. Not only has it benefited from the recent financial crisis which started questioning capitalism, but also the fact that we are currently living in a world, in which the top ten percent of households in almost all advanced countries own approximately 60 to 70 percent of the total capital, contributed to the success of this book. Those inequality levels are too immense even for tolerant Americans and conservative Europeans.

Last but not least, it is the right time because the empirical analysis provides insights on the ongoing Eurozone crisis. To put it in a nutshell, the book is published in an unprecedented environment of high inequalities, uncertainties, and imbalances in Europe and the world. All in all, this explains the public popularity of the book.

2.2. Piketty’s View on the Eurozone Crisis

Next, let me draw lessons for the Eurozone crisis from Piketty’s work. In my view, the most striking finding of the book on Europe is not written in Chapter 16, which is about the Eurozone. Instead let us look to Figure 5.3, in chapter 5 of the book. Piketty shows the different levels of private capital in relationship to national income across the major advanced countries (Figure 2). What can we learn from this Figure, apart from Piketty’s interpretation on increasing concentration of private capital in almost all countries?

First of all, we have to keep in mind that the origin of the
Eurozone crisis has mainly emerged due to macroeconomic imbalances, hence a divergence in competitiveness. Normally, current account imbalances can be eliminated via adjustments of the bilateral exchange rate. However, in a monetary union, the exchange rates are irrevocably fixed. Consequently, the only feasible mechanism is an immediate price and/or wage adjustment. This may eliminate the imbalances and close the competitiveness gap. However, this policy response is sometimes painful for ordinary citizens in deficit countries. Moreover, wage cuts alone cannot restore competitiveness and confidence in an economy. At the same time a current account deficit country has to enforce structural reforms to get the economy back on track as soon as possible. But policymakers delay those policy measures, such as wage cuts and structural reforms at any time, due to the well-known political business cycle [8]. This observation is an unambiguous lesson after more than ten years of the European Monetary Union and the history of economics [9]. Obviously, these two policy measures are often judged as one-sided and therefore disputed especially in current account deficit countries such as France, Italy, Spain, Greece, and Portugal. Indeed, these countries demand that surplus countries should increase wages and prices at the same time to reduce their competitiveness.

In general, both arguments are economically effective. But the book provides insights that the current approach in Europe imposed by surplus countries is more valid and just. In other words, the continuation of austerity is not only appropriate, it is even better to counteract the current challenges in respect of increasing inequalities within and across Eurozone countries. This evidence is even supported by the recent annual report of the independent and highly regarded German Council of Economic Experts [10].

![Figure 5.3. Private capital in rich countries, 1970-2010](source)

The argument of surplus countries –of course Germany, first in line– is as follows: austerity measures in deficit countries are needed to regain international competitiveness in the Eurozone as a whole. The Eurozone competes not merely internally rather with America and Asia. Therefore, current account deficit countries have to cut prices and wages, and not the other way around. This economic argument is supported by the most recent economic findings [10]. Simultaneously, as long as deficit countries cut prices and wages as well as implement reforms, the Eurozone surplus countries assist via European rescue facilities, such as the European Stability Mechanism (ESM). Furthermore, current account deficit countries under European rescue programs obtain additional support from new monetary policy measures by the European Central Bank (ECB). This sounds like and is a balanced and prudent strategy. However, some people in both surplus and deficit countries reject this balanced approach. A reason for this rejection behavior has to do with typical human heuristics and biases in decision-making under uncertainty. These decision-making paradoxes were already discovered by Kahnemann and Tversky [11] decades ago.

2.3. Piketty’s Contradictions

Not surprisingly, Piketty himself refuses the current rescue strategy in the book. However, he argues against all scientific
evidence presented in the first two parts of his book. In addition, the balanced approach is in line with recent findings in economics [7,10,14] and psychology and behavioral sciences [4,11].

Let me briefly elaborate this point for the Eurozone crisis. When the European Monetary Union (EMU) was established, the real interest rate was negative in almost all current account deficit countries of today. That implies that, in the past 10 years, these countries have accumulated massive investments and future wealth. This is literally the true source of the Eurozone crisis and the rising inequalities within and across Eurozone countries (Figure 2). The development of the private capital levels in Italy and France as examples for two large deficit countries, and Germany as a surplus country is well represented in Figure 2. Three distinct patterns can be identified in almost all graphs in Piketty’s book over the past 40 years: i) similar capital inequality levels before 1990, ii) rising capital inequalities in the convergence phase from 1990 to 1998, and iii) finally divergence since the currency union in 1999. The real estate bubble in some deficit countries such as Spain is just another proof. At that time, Germany had the lowest output growth and the highest unemployment rate in Europe, particularly in the period between 2000 and 2005. Without any help from other Eurozone countries, the German government imposed reforms in the labor and goods market. Now, almost 10 years later, Germany is benefiting from these and many other reforms over the past decade in terms of competitiveness and economic growth. On the flip side of the positive economic development in Germany of today, the real wage is lower than 10 years ago and Germany has the largest low-income sector in Europe.

The empirical evidence on rising inequalities across deficit and surplus countries adds an important fact to a controversial debate in the Eurozone. Unfortunately, Piketty does not study this issue in the book explicitly. Consequently, it is a fair request of the domestic taxpayers in surplus countries that deficit countries should pay their own bill for the past (domestic) policy failures. It is strange that Piketty never mentions this fact in the book at all. Instead, he uses ideological glasses such as a policymaker who would never admit an own policy failure and instead blames Europe or other countries. Figure 2 and Figure 3 show that Germany is less wealthy than any other European country even in the long-run. This fact is also proven in other studies by the European Central Bank [12] and Kalckreuth et al. [13] (Figure 3).

The ECB [12] finds that the median and mean net wealth of euro area households is 109 200 Euro and 230 800 Euro respectively. The substantial difference between both numbers is explained by the uneven distribution of wealth within countries. In addition, the ECB explains the difference in household net wealth across countries as follows [12]: “...the two countries with a homeownership rate below 50%, namely Germany and Austria, the “median” household does not own the main residence and has substantially lower wealth than the median household in countries where the homeownership is above 50% (...).” This evidence supports my argument that crude policy demands from current account surplus or presumably rich countries do not necessarily reduce income and wealth inequalities. As a matter of fact, Piketty’s idea of debt mutualisation does not tackle the structural economic problems within some of the Eurozone member states, such as
France and Italy.

It is remarkable that Germany is immediately seen even in Piketty’s eyes, just after a few good years but with painful reforms a decade ago, as Europe’s richest economy. Admittedly the GDP growth and income per capita is high in comparison to most of the other Euro area member states after the great recession of 2009. But at the same time, the rich states are sometimes lagging behind in terms of wealth levels and the degree of inequality, as confirmed in the book. Therefore, the preceding successful years are not a result of German strength rather a result of bold labor market reforms enforced by a left-wing government in office at that time. Thus, tackling the Eurozone crisis with a mixture of austerity and reforms, as Germany did it 10 years ago, seems to be a balanced as well as ‘left-wing’ approach [14]. Consequently, at present the Eurozone surplus countries are doing well due to past and bold reforms, which other countries have been postponing for several years. Hence, today, deficit countries are paying the bill for their own policy failures and ignorance. Even Piketty realizes this issue while studying the data. He attempts to relativize this finding by comparing rich and poor countries at the end of the book (p. 465ff., [3]), unfortunately this subsection does not convince an informed reader.

3. Conclusion

In summary, Part I and Part II of the book ‘Capital In The Twenty-First Century’ are a stimulating source for the debate about rising inequalities and the future of Europe. However, the book lacks on a theoretical foundation especially in respect of psychological and behavioral elements. Moreover, the demand for debt mutualisation and easing austerity in Part IV of the book, would be foolish, socially and economically short-sighted, and unjust at the same time. Nevertheless, other proposals in the book such as the global tax on capital are well established. As a result, Piketty’s work is not just a book on inequalities. It is a remarkable study that sheds light on long-run inequalities and social imbalances across different times and spaces. Thus, it provides interesting lessons for modern democracies’ in America and Europe alike.

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