

Piketty's Determinism?

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In this review of Piketty's book, Capital, we argue that Thomas Piketty's determinism (which suggests that inequality is set to continue to rise indefinitely and that interest and growth are on a preordained trajectory) is wrong. Things don't have to be this way. Thomas Piketty's approach, we argue, arises from his fundamentally neo-classical approach to interest as the marginal product of capital.

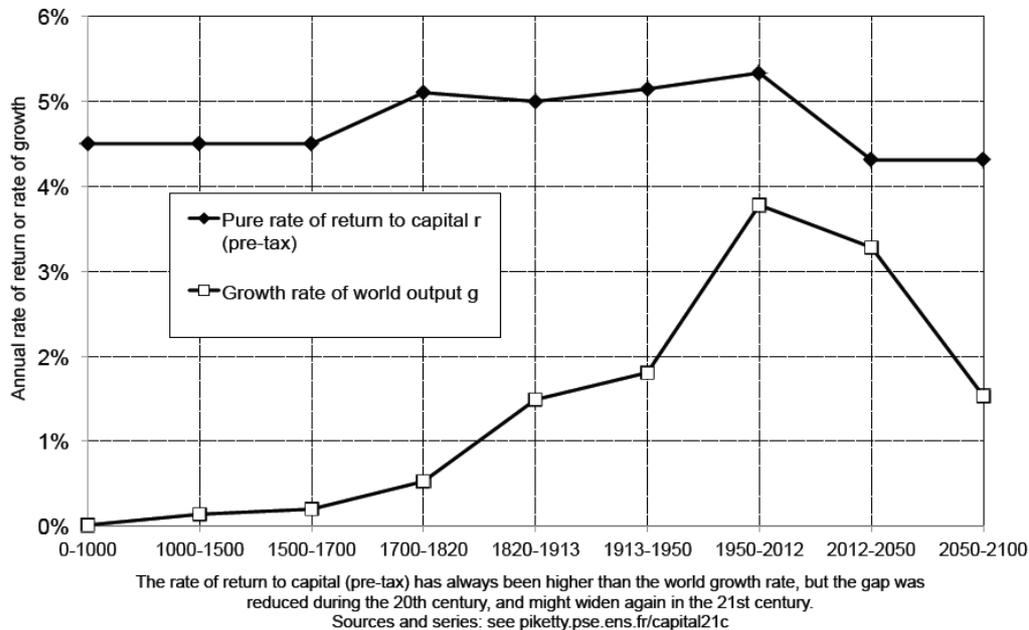
On our worldview, substantial and sustained interest rate changes follow from progressive governments taking control of money. The level of output and employment is then a function of interest so obtained.

1. Introduction

There can be no doubt that Thomas Piketty's book *Capital in the Twenty-First Century* has helped catapult inequality to the top of the global agenda, particularly in the United States. So concerned is the global elite, that the World Economic Forum is in the process of "overhauling how the institute examines growth", and has a WEF economist Jennifer Blanke declaring that "it is extremely important to include the issue of income inequality in how we assess countries".¹ The book has rattled the American Right and placed it on the defensive. The *Wall St Journal* has had to resort to rhetoric about a "neo-Marxist polemic".² The book is also a publishing sensation, one overlooked by the world's biggest conglomerates, and published instead by the Belknap Press at Harvard University Press.

These are all considerable achievements for its author. We are therefore uneasy contesting a progressive work that has done much to raise issues of equity. Nevertheless we find, as many others do, that the work remains in the mainstream tradition that for many has been proven flawed. In this contribution we address specifically TP's determinism, exemplified as we see it by his two millennia time series history of interest rates and growth. He shows these on Figures 10.9 and 10.10; the first is reproduced below.

Figure 10.9. Rate of return vs. growth rate at the world level, from Antiquity until 2100



¹ In 'An unequal world is an uncharted economic threat' by Gillian Tett, *Financial Times*, September 4, 2014. <http://www.ft.com/cms/s/0/f0a593b2-3413-11e4-b81c-00144feabdc0.html?siteedition=uk#axzz3CYlfaRmR>

² 'Money' by Steve Forbes and Elizabeth Ames, reviewed by George Melloan, *WSJ*, July 24, 2014. <http://online.wsj.com/articles/book-review-money-by-steve-forbes-and-elizabeth-ames-1406243735?KEYWORDS=Forbes>

The discussion here proceeds by deconstructing each variable (sections 1 & 2), addressing interactions (3), and concludes with policy (4). We include some discussion of sources, for it is striking that these central explanatory variables of his analysis are considerably less firmly-based than those related to outcomes.³

While it is encouraging to see interest rates reverting to a central position in such a high-profile piece of economic analysis, the manner of both his theoretical and empirical interpretation must be contested. Our own work on the role of interest rates in economic outcomes, leads to very different theoretical and practical conclusions (eg Pettifor, 2014 and Tily, 2010).

2. Growth

TP appears to consider that the extent of economic activity (as opposed to its distribution) through history is reasonably and sufficiently represented as a series of output growth. Moreover it is not implausible to project this measure one century into the future.

This historic record of growth owes everything to Maddison's dataset,⁴ beyond an update in the more recent years. These figures are surely very far from a matter-of-fact, notwithstanding any associated painstaking research. Presumably this worldview must have been contested, but any scepticism must be reiterated: is it plausible to portray the dynamic of world history as a relatively smooth function of this kind? An alternative interpretation would regard history as non-linear and discontinuous, and not so obviously represented in growth space. Plainly any such assessment on our part must be subjective, and certainly no matter for economists alone. But our crude reading of history suggests that ancient Mesopotamia gave way to Egypt and then to Greece, and, after a Roman interval, to Byzantium. The medieval glories of Venice and Northern / Norman Europe, after darker ages, led to the Renaissance, Reformation and Enlightenment. An Imperial age finally gave way, after the Great Depression and Second World War, to a golden age of more progressive, equitable and democratic nature; and this was then gradually undone. Whether it is meaningful to make assessments of growth both within or between all these civilisations is surely highly contentious.

For GDP is a measure devised in the 1930s and 1940s, that evolved into an ideology and rationale for progress that has existed for only a little more than half a century. The imposition of this – ultimately technocentric – view on history is far from unquestionably legitimate. It is only on this basis that TP can assert that there is “no doubt whatsoever” (p. 74) that the pace of growth was quite slow from antiquity to the industrial revolution. Such a perspective presumably explains why there is very little

³ Though exactly how these figures are derived, and whether they are independent of earlier assessments of α and β , we cannot say for sure and would welcome clarification on these matters. After such a massive read, this lack of clarity is troubling.

⁴ Technical appendix to Chapter 1.

discussion of the trajectory of growth: it follows naturally from technology and invention leading matters, and common sense apparently tells us the trajectory of invention. While TP appears fairly well disposed towards the state on distributional grounds, his description of the golden age still has supply in the driving seat in terms of aggregate activity: “the very rapid expansion of the role of government in the three decades after World War II was greatly facilitated and accelerated by exceptionally rapid economic growth” (p. 481).

3. Rate of interest

Others have contested TP’s approach of conflating industrial and other non-financial capital with financial capital,⁵ and emphasised the fundamentally neo-classical approach to interest as the marginal product of capital. But ‘the’ rate of interest (as Keynes saw it) requires careful consideration, in a way that has not been the case for some time, in both convention and mainstream literature.

Piketty’s definitional confusions are perhaps symptomatic of this state of affairs. His emphasis on wealth, leads to a view of interest as a return on the part of wealth holders. This follows from his definition of ‘capital’, derived deliberately from the French ‘patrimoine’ and not from the more common ‘richesse’. (The French language title to Adam Smith’s *Wealth of Nations* is *la Richesse des Nations*). ‘Patrimoine’ is translated almost everywhere in the English edition of Piketty’s book, as ‘wealth’. But the primary sense of ‘patrimoine’ in French is not just ‘wealth’ as a snapshot of a person’s current property of all kinds, or as an additive list of property at a given moment, but rather as a ‘heritage’, or an ‘estate’. That said, developments since the financial liberalisation process that began in the 1970s mean that his main thesis is right. Wealth is begetting obscene wealth, which is not taxed or otherwise impeded in its mobility or accumulation, and today faces few barriers in its transmission from generation unto generation. It is a bleak picture.⁶

On a theoretical basis, it was Keynes’s insight that any such return to which the rentier was accustomed and would subsequently demand could be very different to any likely return on physical capital investment. Similarly TP sees that his empirical assessment of interest rates is problematic from the point of view of neo-classical theory. As Kapeller (2014) observes, sustained high returns are not consistent with diminishing returns to capital. TP effectively amends mainstream doctrine:

Technological development has brought along highly differentiated and multilayered means of investment, which devalue the old principle “too much capital kills the

⁵ From the national accounts perspective, the share of gross operating surplus in the income measure of GDP does not correspond to any such return on capital. Yet this flow estimated at 30 per cent is compared with wealth as a share of income at 600 per cent as one way of deriving an interest rate at 5 per cent.

⁶ And yet, maybe the picture he paints is not bleak enough. For his definition of “capital” is in essence a financial calculation of owned assets minus liabilities. Leaving aside other definitional issues, what is missing, or not pursued, is the power that great wealth gives itself not only to further accumulate rapidly – but also the power gained through access to credit and other forms of financial manipulation to debt-finance gains.

return on capital”. “This is perhaps the most important lesson of this study thus far: [...] because capital has many uses one can accumulate enormous amounts of it without reducing its return to zero” (TP in Kapeller, p. 4).

Equally, the methodological approach underpinning TP’s empirical assessment on Figure 10.9 seems highly contentious. The historical series appears to rest on his observation that:

I write on p.207 that the interest rate on the public debt is typically around 4%-5% per year during the 18th and 19th centuries. One of the most documented cases is the United Kingdom, where we have quite complete annual series started at the end of the 17th century and the beginning of the 18th century. We notice that returns often reached 5%-6% in the 18th century, or even 6%-7% at the end of this century and at the beginning of the 19th century (and during the Napoleonic wars; see appendix to chapter 3), then progressively decreased again during the 19th, to eventually be barely 3%-4% at the end of the century (or even less than 3%, while in a deflationist context, so that the real returns were in fact significantly higher). See series gathered in *Capital is Back...*, 2013 (in particular Table DataUK4). The series that are available for other countries, specially France and the United States, are less systematic but show the same kind of evolutions and fluctuations around an historical mean about 4%-5% in the 18th and 19th century (Technical appendix, pp. 36-7).

These observations on nominal government rates for three countries across three centuries, seem to be the foundation for two millennia of global figures. Surely this cannot possibly capture a dynamic that Homer and Sylla (2005) – authors of the monumental *A History of Interest Rates*⁷ – depict in these terms:

Students of history may see mirrored in the charts and tables of interest rates over long periods the rise and fall of nations and civilisations, the exertions and the tragedies of war, and the enjoyments and the abuses of peace. They may be able to trace in these fluctuations the progress of knowledge and of technology, the successes or failures of political forms, the long, hard, and never-ending struggle of democracy with the rule of the elite, the difference between law imposed and law accepted (p. 3).

Interest and money have been the dominant preoccupation of political, academic and religious classes since the dawn of civilisation. Correspondingly, it has been a central preoccupation of certain progressive authorities to facilitate reductions in interest. In his time series, TP may betray a wider lack of interest or even ignorance on the part of recent academic and policy discourse to the great part of academic history (beyond narrower questions primarily concerning discount rates).

The rates on the British government bonds – consols – that are so valuable to TP’s assessment were the outcome of hard fought institutional developments, not least the

⁷ Cited only incidentally and on a technicality by TP: n. 16 to Chapter 10.

instigation of the Bank of England under William of Orange and Robert Walpole's great advances in the management of the public finances. Half a century before, in his *Brief Observations Concerning Trade and the Interest of Money*, Sir Josiah Child (1630-1699)⁸ looked to the prosperous and financially advanced Netherlands:

Their use of BANKS, which are of so immense advantage to them, that some not without good grounds have estimated the profit of them to the Publick to amount to at least one million of pounds sterling per annum. ... [However, discussion focuses on] The Profit That People have received, and any other may receive, by reducing the Interest of Money to a very Low Rate. This in my poor opinion, is the CAUSA CAUSANS of all the other causes of the Riches of that people; and that if Interest of Money were with us reduced to the same rate it is with them, it would in a short time render us as Rich and Considerable in Trade as they are now (Child, 1668).

Moreover, while Bank rate was set at 5 per cent for over a century, Consols were most famously established at 3 per cent.

More recently in 1945, after the National Debt Enquiry (see Tily, 2010, appendix to chapter 3), HM Treasury set out the framework for post-war debt management policy that would be adopted by the first majority Labour Government in history:

6. *General desirability of low rates.* There is a wide measure of agreement, though not complete unanimity, in the present Committee in the view that on the whole, subject to the qualification dealt with in paragraphs 11 to 15 below, the desirable ideal for this country for a long time to come is not merely the continuance but even the reduction of the existing relatively low levels of interest rates both for long term and for short.

The lower rates achieved were a feature of the golden age across the world. Fundamentally they were the outcome of *deliberate* monetary action. Keynes's notion that the rentier could become accustomed to a lower rate of return was vindicated.

In TP, this reduction in rates is seen on his Figure 10.10 where an adjustment for tax and capital losses leads to the rate of return falling to 1 per cent over 1913-50, and staying close to 3 per cent over 1950-2012. It is the only movement of any note in history, and is explained as a result of the expanding role of the state and introduction of progressive income taxation motivated by the Great Depression and World Wars. Matters revert to normal with "the political shifts of the past several decades, especially in regard to taxation and finance"

(p. 20). We agree that over this period (real) interest rates reverted to historic highs, but would place all emphasis on institutional developments leading to the liberalisation of finance.

⁸ Merchant, economist, politician and governor of the East India Company.

The rentier did not tolerate low rates indefinitely.

4. Interest, output and distribution

As all his readers know, for TP the distribution of income and wealth depends on the relation between interest and growth. According to the preceding discussion the lines are interdependent, to the extent that a high marginal product drives high growth. But it is not clear how important this is for TP. His main emphasis is on the specific episode of the golden age/*trente glorieuses*, when the post-tax rate of interest falls below growth ($r < g$) and the great narrowing in distribution of the twentieth century began. Moreover this is the only more equitable episode in history. For the rest of history his empirics imply that the wealth distribution has only widened. We are sceptical of both his theoretical reasoning and empirical judgements.

Issues of causality as well as interdependence are opaque, but plainly for TP matters are determined on the real side, primarily as a consequence of technological advance. But the actions of the financial authorities over history are inconsistent with this reasoning. While Homer and Sylla carefully avoid generalisations on cause and effect, their analysis shows great ages of civilisation accompanied by material and sustained reductions in interest, and conversely darker ages by severely elevated rates. Josiah Child got the low rates of interest he sought, and the financial environment permitted Britain her economic and political pre-eminence on the global stage for over a century. The National Debt Enquiry likewise, and the golden age ensued. In the *General Theory*, Keynes was clear that causality was from the rate of interest to aggregate activity. So any relation between interest and growth is far more complex than TP implies, and fundamentally contingent on human initiative.

Distributional considerations were not his central concern, but Keynes's perspective likely arrives at the same place as TP with regard to a narrowing of the income and wealth distribution in the Golden Age. With the interests of the wealthy no longer paramount, he rejected conventional arguments against income and inheritance taxes. Lower returns on capital were inherent to a cheap money policy, obviously. Moreover lower unemployment plainly advantages labour.

That said, looking further back into history it seems unlikely that other civilisations saw only regressive times, and it is far too crude to see only continuously increasing inequality on any global basis. Our empirical judgements suggest a far more complex trajectory through history for interest and growth (or the level of activity), and our theoretical reasoning leads us to reject such a straightforward relation between interest, growth and the income distribution.

Nonetheless we are in full agreement that developments since financial liberalisation over the 1970s have tended to a severe inequality of income and wealth. TP argues too that inequality is set to continue to rise indefinitely on the basis of the ongoing reversion of growth back below and interest (with slower population growth playing a part). Again we agree, though we reach this conclusion as representing a consequence

of the reversal of Keynes's approach set out above, given lower taxes, higher returns to the wealthy and higher unemployment of the liberalised age. But the fundamental point is that it doesn't have to be this way.

5. Policy

TP rescues himself from a deterministic straitjacket and from an economic history that is pre-ordained through his emphasis on distributional and associated policies; though his regarding the recommended policies as implausible in practice must be problematic. In the meantime attention is diverted from more fundamental matters of monetary architecture, economic and financial stability, and unemployment. Income distribution is only one of a number of symptoms of a liberalised system that has failed in a spectacular way. The global financial crisis which has gravely exacerbated an already severe failure to deliver work – and decent work – to the vast majority of the population must be our paramount concern. (The word unemployment does not feature in the index of the English edition.)

On our worldview, substantial and sustained interest rate changes follow from progressive governments taking control of money. The level of output and employment is then a function of interest so obtained. So the golden age *was* because of low interest, but it was not a happy coincidence of exogenously driven growth coupled with progressive taxation policies. In a fleeting recognition that such a worldview might exist, TP has a cursory look at usury laws (p. 531), and dismisses them as initially wrongheaded and finally conflates such initiatives with those he regards as ending in the Soviet Union.⁹ This is very disappointing in a work that purports to be progressive.

⁹ Though his rhetoric is occasionally more ambiguous. He concedes China is doing well without international finance (funding all from savings, p. 71), but finance is “not all ...bad ... to some extent natural and desirable” (p. 42).

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