What Thomas Piketty Gets Wrong About Capitalism

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It's hardly a mystery why Thomas Piketty's *Capital in the 21st Century* has generated so much intellectual excitement here in the United States. The subject of the book, economic inequality, has become in recent years a major fault line in American ideological and partisan conflict. President Barack Obama, for his part, has called it "the defining challenge of our time."

And now, in the grand tradition of Frenchmen who explain us to ourselves, along comes Professor Piketty with a magisterial work whose painstaking empirical rigor is matched only by its vaulting theoretical ambition. Peering into centuries of income and wealth data for countries around the world, Piketty has found what he believes to be a fundamental law of capitalism: r > g.

There is an inherent tendency, he argues, for the return on capital (r) to exceed the rate of economic growth (g). As a result, the ratio of wealth to incomes rises over time with baleful consequences for the distribution of income and opportunity. The shape of things to come, Piketty warns, is a "patrimonial capitalism" in which the inherited wealth of an entrenched plutocracy dominates economic, social, and political life. An admiring Paul Krugman, writing in *The New York Review of Books*, proclaims that Piketty's bold thesis "amounts to a unified field theory of inequality."

Ah, but there's a catch—and Krugman, to his credit, spots it. In what Krugman calls "a sort of intellectual sleight of hand," Piketty offers an explanation for the rise of U.S. income inequality that is quite distinct from the purported relationship between r and g. "The main reason there has been a hankering for a book like this is the rise, not just of the one percent, but specifically of the American one percent," Krugman writes. "Yet that rise, it turns out, has happened for reasons that lie beyond the scope of Piketty's grand thesis."

So what has been driving the growing spread in U.S. incomes? According to Piketty, the main story has been, not the relentless accumulation of capital, but the vertiginous rise of labor incomes at the very top of the pay scale. Indeed, U.S. income trends over the past generation appear "fractal" in nature—that is, the same pattern repeats itself at progressively smaller scales. Thus, compare the top 10 percent of American earners to the other 90 percent and you'll see the high earners pulling away from the pack: Piketty's data show that their share of total income rose from below 35 percent in the 1970s to nearly 50 percent in the past decade.

But you'll see the same thing if you drill down an order of magnitude and focus just on the top decile, only this time it's the top 1 percent of earners pulling away from the rest of the top tenth. Drill down once more by comparing the top 0.1 percent of earners to the rest of the top centile and you'll see the same thing again. "Of the 15 additional points of national income going to the top decile," Piketty writes, "around 11 points, or nearly three-quarters of the total, went to 'the 1 percent' (those making more than $352,000 a year in 2010), of which roughly half went to 'the top 0.1 percent' (those making more than $1.5 million a year)."

Although the brilliance of Piketty's empirical work is widely acknowledged, its ultimate accuracy is not beyond dispute. In particular, Cornell economist Richard Burkhauser has used a different but plausible methodology to measure incomes and finds no rise in inequality since the 1980s. (Scott Winship of the Manhattan Institute offers a useful comparison of Piketty and Burkhauser's methodologies and results here.)

But for present purposes, let's assume Piketty's numbers are right. And if they are, then all the *Sturm und Drang* over rising U.S. income inequality boils down to a complaint about trends at the very tippy top of the income scale—those 150,000 or so top earners who, in any given year, comprise the top 0.1 percent. (Of course there is considerable turnover in that group from year to year, and thus the specific members of the club change over time.)

Who are these people? Piketty relies on the analysis in a 2012 working paper by Jon Bakija of Williams College, Adam Cole of the U.S. Treasury Department, and Bradley Heim of Indiana University. According to their work, roughly 60 percent of the top 0.1 percent are executives, managers, and financial professionals (41 percent in non-finance, 19 percent in finance). Lawyers, doctors, and real estate developers make up another 15 percent or so, while media and sports stars constitute under 4 percent. Piketty surveys these data and concludes that "the new US inequality has much more to do with the advent of 'supermanagers' than with that of 'superstars.'"

Here then is the crux of the matter, according to Piketty: "This spectacular increase in inequality largely reflects an unprecedented explosion of very elevated incomes from labor, a veritable separation of the top managers of large firms from the rest of the population." And indeed, executive compensation has skyrocketed in recent decades: according to one measure, average compensation for CEOs has risen (in inflation-adjusted constant dollars) from about $1.1 million in 1970 to $10.9 million in 2011 (down from a peak of $18.2 million in 2000). Although the escalation in CEO pay is probably the most dramatic, other senior corporate executives have also experienced whopping increases in remuneration.

What accounts this phenomenon? Piketty says there are two alternatives. One, which fairly reeks of moldy straw, is that "the skills and productivity of these top managers suddenly rose in relation to those of other workers." The other, favored by Piketty, is that "these top managers by and large have the power to set their own remuneration." "It may be excessive to accuse senior executives of having their 'hands in the till,'" Piketty writes, "but the metaphor is probably more apt than Adam Smith's metaphor of the market's 'invisible hand.'"

For Piketty, the only plausible explanation for skyrocketing executive pay is self-dealing: managers are taking advantage of weak corporate governance to benefit themselves at the expense of shareholders. This is certainly a popular view, and it has its scholarly defenders—most notably, Lucian Bebchuk and Jesse Fried at Harvard Law School. But there is one rather glaring problem with the theory: by all accounts corporate governance has improved considerably in recent decades, just as CEO pay has gone through the roof. Consequently, "none of the evidence that we have found suggests that the ability of executives to set their own pay can explain the dramatic increase in compensation over the century"—so conclude Carola Frydman of MIT and Raven Saks of the U.S. Federal Reserve in a 2010 paper that surveys trends in CEO compensation since the 1930s.

If abuse of managerial power isn't the answer, what is? The vexing fact of the matter is that nobody really knows: the long-term trends in executive compensation defy easy explanation. Increases in firm size, greater reliance on equity-based pay to better align managers' incentives with the interests of shareholders, the great bull market of 1983-2000, more intense competition for top talent as reliance on promotion from within the firm has lessened, the stimulus provided by lower income tax rates to bidding wars for top talent, adjustments for risk as executives' tenure has grown less secure, changing cultural norms about both loyalty to one's employer and the seemliness of huge pay packages, government interventions relating to compensation and their often unintended consequences—all these factors and others besides have likely played a role in the story.

In the bigger picture, there doesn't seem to be anything especially distinctive about corporate executives compared to other members of the top 0.1 percent. Top lawyers and surgeons, hedge fund managers, venture capitalists, media and sports stars—all have seen comparable increases in pay.

This isn't to say that executive compensation isn't problematic. There is no obvious way to tell in advance what corporate managers are really worth, nor is there any perfect compensation structure that optimizes the incentives that executives face. Meanwhile, the stakes are large: Product market competition may provide the ultimate discipline for wayward managers; but well-designed compensation systems hold out the promise of avoiding waste on a colossal scale.

Although solving, or at least not botching, the riddle of executive compensation is important, it is nonetheless a fairly narrow and technical issue. We're talking about figuring out the appropriate level and structure of remuneration for about 100,000 positions in a 140 million-worker economy.

This is the real sleight of hand in Piketty's magnum opus: call it the incredible shrinking inequality problem. Krugman, while noting that Piketty departs from his profundities about r and g to explain U.S. inequality, treats that departure as simply inelegant—a bit of necessary ad hockery to make sense of a messy world. But the way I see it, the contrast between Piketty's main theoretical edifice and the little outbuilding he constructs to account for the United States is of much greater significance.

I call it a bait and switch—perpetrated not by the author on his audience, but by his most admiring readers on themselves. Piketty is being celebrated for supposedly demonstrating that the deep structures of capitalism tend toward ever-greater inequality. But in the United States—the most unequal of all the advanced economies—the main explanation offered for the growing gap between rich and poor is that 100,000 or so corporate managers are being overpaid. What's getting all the attention is Piketty's depiction of rising inequality as the tragic flaw at the heart of the entire capitalist economic system. But what's really going on, at least according to Piketty, is a comparatively narrow and shallow problem of corporate governance.

Getting CEO pay right is surely a challenge, but does anybody on earth think it is the defining challenge of our time?