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Review by: Melissa S. Kearney

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How Should Governments Address Inequality?

Putting Piketty Into Practice

Melissa S. Kearney

After Piketty: The Agenda for Economics and Inequality

EDITED BY HEATHER BOUSHEY, J. BRADFORD DELONG, AND MARSHALL STEINBAUM. Harvard University Press, 2017, 688 pp.

In 2014, an unusual book topped bestseller lists around the world: *Capital in the Twenty-first Century*, an 816-page scholarly tome by the French economist Thomas Piketty that examined the massive increase in the proportion of income and wealth accruing to the world's richest people. Drawing on an unprecedented amount of historical economic data from 20 countries, Piketty showed that wealth concentration had returned to a peak not seen since the early twentieth century. Today in the United States, the top one percent of households earn around 20 percent of the nation's income, a dramatic change from the middle of the twentieth century, when income was spread more evenly

MELISSA S. KEARNEY is Professor of Economics at the University of Maryland, a Research Associate at the National Bureau of Economic Research, and a Nonresident Senior Fellow at the Brookings Institution. Follow her on Twitter @kearney_melissa.

and the top one percent's share hovered at around ten percent. Piketty predicted that without corrective action, the trend toward ever more concentrated income and wealth would continue, and so he called for a global tax on wealth.

Like much of the popular commentary about inequality, Piketty's book rested on an implicit moral claim—that wealth concentration beyond a certain degree violates the inherent sense of fairness on which a just society depends. But antipathy toward inequality alone cannot drive a policy agenda that will create a more egalitarian society. Critics of inequality need a compelling, evidence-based explanation for how and why the concentration of income and wealth at the top is problematic. Is this inequality the result of a purposely rigged game, or is it caused by unintentional distortions in a basically fair system? Whatever its causes, does inequality impede overall economic growth? Does it undermine widespread opportunity and upward mobility? Does it pose a threat to global capitalism and liberal democracy?

In *After Piketty*, three left-of-center economists—Heather Boushey, J. Bradford DeLong, and Marshall Steinbaum—have curated an impressive set of essays responding to Piketty's work and taking a few steps toward answering those questions. Among them are deep dives into the assumptions underlying Piketty's predictions, historical accounts of the role of slavery and gender in capitalist systems, and considerations of the relationship between concentrated wealth and political power. The essays put Piketty's arguments into a broad historical and intellectual context and highlight some noteworthy omissions that call into question his book's most dire predictions.

At the end of the volume, Piketty himself weighs in. The result is an intellectual excursion of a kind rarely offered by modern economics.

The contributors tend to look backward to history or inward to economic models, which is a natural way to respond to a book that is fundamentally historical and theoretical. But to more fully answer the questions Piketty's book raised and to start crafting policies to tackle growing inequality, economists and policymakers need to know much more than they currently do about the causes and consequences of today's concentration of wealth at the top. To reduce extreme inequality's threat to economic security and upward mobility, the United States needs policies that enhance the skills and opportunities of the disadvantaged. Washington must pursue tax reform and changes to corporate-governance rules that will create more shared prosperity. But policymakers also need to avoid steps that would impede innovation and productivity.

THE TOP OF THE HEAP

In the past four decades, studies of rising inequality in the United States have typically focused on the bottom 90 percent of earners. Economists have produced rigorous evidence demonstrating how trends in technology, trade, unionization, and minimum wages have shaped the fortunes of those Americans. Global labor-market forces have pushed up the demand for highly skilled workers and have led to steadily increasing wages for those with a college education. The same forces have led to declining or stagnant wages for those with lower levels of education. And a decline in unionization rates and the fall in the real value of the minimum wage have exacerbated the

downward pressures on middle- and low-wage workers.

Less well understood are the causes of the tremendous surge in income among extremely high earners, meaning the upper 1.0, 0.1, and 0.01 percent. From a policymaking point of view, the most important question is how much of the ultrarich's income reflects activity, such as technological innovation, that benefits the broader economy. The more of it that does, the greater the potential economic costs of raising taxes on the highest-income individuals. If, in contrast, the income of the biggest earners is produced by pursuits that are less broadly beneficial, such as high-frequency stock market trading, then higher taxes at the top would pose fewer economic costs. Either way, there are likely compelling reasons to raise the top income tax rates—as a way of funding public services and investing in infrastructure, for example. But policymakers would be able to make better decisions about “soaking the rich” if they had a clearer sense of the tradeoffs involved.

One of the most interesting facts uncovered by Piketty and others is that compared with the richest people and families in the early 1900s, when large fortunes often came from inherited assets, today's superrich are acquiring a larger share of their income in the form of earnings. About 60 percent of the income of the top one percent in the United States today is labor income. A number of essays in *After Piketty* mention the rise of “supersalaries” or “supermanagers”: top executives of large corporations, primarily in the financial industry, who enjoy very generous compensation packages. Economists disagree, however, about whether the income earned by such executives reflects the efficient working



Le Penseur: Thomas Piketty in Paris, March 2017

of a market for talent, in which case their pay reflects their value, or whether the massive compensation packages result from a bargaining process that is shaped by regulations, institutions, and social norms.

In their contribution to the book, the economists Laura Tyson and Michael Spence highlight the role of technological developments in creating substantial economic rewards for those who possess specific skills and in reducing the employment security of less skilled workers. But Tyson and Spence also note that markets are imperfect and that compensation packages are not determined solely by market value. They point to a growing body of research indicating that income generated by patents and intellectual property protections and by the market power of brand names flows primarily

to upper-level management and the owners of capital.

In contrast, in Piketty's view, the primary factors driving the rise in executive pay at the top are not technology or imperfect markets but eroded social norms, questionable corporate-governance practices, and declining union power. Tyson and Spence favor more research to weigh the relative impact of market forces and institutional factors but argue that either explanation provides a strong rationale for increasing the marginal income tax rate for top earners in an effort to combat income inequality.

ONE FOR YOU, TWO FOR ME

Another essential set of questions about inequality centers on whether wealth concentration negatively affects economic

growth, shared prosperity, and democratic institutions. In his contribution to *After Piketty*, Mark Zandi, the chief economist at Moody's Analytics, outlines a number of ways in which it might. One such potential negative effect is reduced aggregate consumer spending. Since lower-income households have a higher propensity to spend out of their earnings than do higher-income ones, the more wealth held by high-income households, the less overall spending the economy might see. Another potential problem is that wealthy Americans tend to vote for (and lobby for) lower taxes; increased wealth concentration, then, could lead to harmful reductions in government spending on public goods such as education and infrastructure. Nevertheless, Zandi cautions that the link between income inequality and aggregate U.S. economic growth is relatively weak. "There is evidence that extreme inequality, as prevails in some parts of the world, weakens economies," he writes, "but inequality in the United States doesn't appear to be significant enough for it to make a substantial difference to the economy's prospects."

Even if the income of top earners reflects genuinely worthwhile contributions to society and does not impede economic growth, today's extreme inequality does threaten social cohesion. I used to contend that economists and policymakers need not worry about inequality and should instead focus on reducing poverty and expanding opportunity. But after years of researching the topic, I've come to believe that policymakers cannot achieve those goals without directly addressing inequality.

In the winner-take-all economy of the contemporary United States, the

gap between the top and the bottom has grown so large that it undermines any reasonable notion of equal opportunity. As inequality has increased, the country has witnessed a fraying of communities and institutions and deepening divisions along socioeconomic lines. Children from high-income homes are pulling further and further ahead of their less advantaged peers in terms of education, which means it is far less likely that children born into middle- or low-income homes will experience upward economic mobility. Americans celebrate "rags to riches" stories, but the data indicate that the United States has less social mobility than most European countries. Social mobility in the United States is not yet on the decline, but if current trends continue, it will be soon.

Inequality also harms American society by encouraging negative perceptions of the economy and one's prospects for upward mobility. If Americans view the system as rigged against them and see economic success as out of reach, they might give up on the celebrated American ideals of hard work and meritocracy. That may already be happening. Research I have conducted with the economist Phillip Levine shows that young men are more likely to drop out of high school if they live in places with higher levels of income inequality, all else being equal. This is consistent with evidence produced by psychologists showing that beliefs about inequality negatively affect people's expectations of social mobility.

The alarmingly low rates of labor-force participation among young Americans and those of prime working age might also be driven, at least in part, by a sense of malaise shaped by today's high levels of income inequality. Labor-force

participation among American men aged 25 to 54 has fallen steadily since the mid-1960s, a trend that has been sharper in the United States than in other advanced economies. In 1964, 98 percent of such prime-age men with a college degree or more participated in the work force, as did 97 percent of those with a high school degree or less. By 2015, the rate for college-educated workers had fallen only slightly, to 94 percent, but the rate among less educated men had plummeted to just 83 percent. This drop reflects market forces and technological change, to be sure, but it also suggests shifting social norms and attitudes.

HIGH AND NOT SO MIGHTY

A growing body of evidence now indicates that inequality in the United States threatens to create intergenerational poverty traps, greatly reduce social mobility, and marginalize entire swaths of the population. Such effects are sure to have political ramifications. Piketty proposed that greater wealth inequality will increase the demand for egalitarian policy responses. But it also means that the wealthy, with their deeper-than-ever pockets, will be even better able to block such changes. Beyond that observation, Piketty doesn't have much to say about the politics of inequality in the United States or elsewhere. As the social policy expert Elisabeth Jacobs points out in her contribution to *After Piketty*, politics is both "everywhere and nowhere" in Piketty's *Capital in the Twenty-first Century*: the problems Piketty identifies are inherently political, but he pays little attention to the crucial role that politics would play in any attempt to address them.

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Unfortunately, the same criticism applies to *After Piketty*. Many of the volume's contributors assume that no matter what policy remedies for extreme inequality emerge, wealthy elites will marshal their considerable influence to maintain their position and privileges. But they do not explore those potential policies at great length, nor do they consider the precise mechanisms that would shape pushback from the elites.

After Piketty would also have benefited from more discussion about whether recent political events challenge the notion that elites can overcome a wave of support for more redistribution of wealth. In 2016, the Brexit vote and the American presidential election revealed the strength of populist and nationalist sentiments among voters who gleefully rejected the elite classes in both the United Kingdom and the United States. Even in the wake of such surprising outcomes, the political economy models described in *After Piketty* tend to associate rising wealth concentration with growing political power of the elite—not the rise of populism. The watershed political events of 2016 call those models into question; in both the United Kingdom and the United States, elites saw their preferred choices lose out.

E PLURIBUS UNUM?

When it comes to the problem of income and wealth inequality in the United States, there are no silver bullets. But policymakers have many levers available to them. The best evidence suggests that the United States could have a more progressive federal income tax code without incurring substantial economic costs. Tax reform should focus on expanding the tax base by closing

loopholes and eliminating regressive features such as the mortgage-interest tax deduction, which benefits only high-income homeowners, and the carried-interest loophole, which benefits only those involved in private-equity finance.

The federal government should take the additional revenue such steps would generate and invest it in programs that would increase the country's economic potential. That would include improvements to public infrastructure, expanded access to high-quality childcare and preschool programs, and more spending on programs that assist economically disadvantaged youth. Government commitments to public universities and community colleges must be strengthened. At the same time, institutions of higher education must focus on helping their students build the skills they will need to succeed in a competitive, rapidly changing labor market. These types of investments are crucial if the United States is to remain a land of opportunity. ②