DISEASE, DOCTORS AND UNPLEASANT MEDICINE

Thomas Piketty's book is a search for the cause of poverty's persistence amidst what appears to be astounding progress. His wide-ranging exploration through time and around the world reveals both common tendencies and characteristic deviations. He uses these to suggest where the cause of this continuing injustice may lie and what might be done about it.

Piketty has examined a sick patient, expounded a diagnosis of their condition and prescribed medicine. However, the diagnosis and treatment have upset the patient's feelings, still dulled through engrossment in theory and economic models. This upset has manifested through many questions about mainstream economic understanding by economists, and this has followed so soon on the wake of questions after the 2007 financial catastrophe.

Adam Smith, the original economic doctor, examined the patient and published his diagnosis of a severe bout of mercantilism 239 years ago. If his prescription of free markets, specialisation and wise investment was followed, he presented a vision of universal opulence. His vision inspired the world and still lingers in our hopes and dreams. However the reality of today as described by Piketty is more like a universal disease of extreme inequality.

A century after Smith's diagnosis, Henry George re-examined the patient and published his diagnosis. He prescribed a medicine which proved to be too difficult to swallow. Mainstream economic thought considers him at best irrevelant, nevertheless his advice remains and resurfaces every now and then even in publications such as *The Economist* and *The Financial Times*.

It is Piketty's effort that has most attention today. He diagnosed a critical condition of progressive inequity, possibly terminal. His prescribed treatment is an unpleasant medicine, an aggressive and progressive wealth tax applied as universally as possible. He looks at the patient and holds little hope that they will swallow it. Feeling as ill as we do today, perhaps we should seriously look at what all three doctors advised. Piketty's book has been widely reviewed, yet some of the unanswered questions he poses are well worth consideration, especially by reference to the other doctors.

Smith's vision begins this consideration. This is followed by Piketty's main argument, and then some of his points of reflection; how George's diagnosis makes sense of the other doctors will be a fitting conclusion.

SMITH'S VISION OF OPULENCE

For Smith, the great disease of the time was mercantilism in the forms of both trade restrictions favouring a few, and national policy of bullion hoarding, at the time believed to make the nation rich. He railed against all forms of monopolistic practice and explained that real wealth was to be found in people's use of goods and services rather than in bars of gold. His instinct for the "hidden hand" and his observation of the widespread benefits from both division of labour and the free marketplace were revolutionary. Opulence arose where free endeavour and exchange prevailed.

Smith did not stay in the pin factory but looked across the world and back in time, gathering evidence, sifting it through and formulating simple yet fundamental conclusions. At any point in time, some nations were obviously wealthy whilst others were poverty-stricken; hence the book title, *An Enquiry into the Causes of the Wealth of Nations*.

One conclusion of immediate relevance is investment. If some effort was diverted from producing immediate rewards of consumption, it can create capital (stock) in the form of whatever makes human effort more effective. After a time the investment pays off as more goods and services being available from a given effort. The nation as a whole can only benefit; life could only get better if this good medicine was taken and those mercantilist potions discarded.

Smith explains this in terms of human effort and reward as just described, and also in terms of money. Considering effort and the resulting goods and services which satisfy human desires avoids any confusion regarding money; it also acknowledges how goods and services are actually created. His explanation in terms of money describes how some of the profit gained by the capitalist is reinvested in capital to further improve efficiencies of production; however this obscures where profit arises from.

Smith saw landlords, capitalists and labourers around him, with clearly distinct positions in the economic world. He understood the potential of a landlord's monopoly position, being similar to those of trade restrictions practised in towns and guilds of the time. In the grandness of his vision he explained this away in terms of the landlord needing artisans to improve his land; indeed he described all three participants needing each other, and had through his earlier work *Theory of Moral Sentiments* already explored native altruism in people. Hence the "hidden hand" and the free marketplace would ensure fair play and the benefits of productive investment would be distributed with reasonable equity. This mutual dependency embodied the vital checks and balances that underpinned the free market.

PIKETTY'S DIAGNOSIS

The symptom that triggered Piketty's examination of the patient was pervasive inequality, a word used on every other page in his book. This contrasts with the shared opulence envisioned by Smith and expressed in modern economic thought as "a rising tide lifts all boats".

For there to be any chance of the patient's recognition of their diseased condition, his team had to work hard gathering evidence through statistics from twentieth century onwards, through historical evidence, through novels, and throughout the world. The evidence presented in this book is compelling.

And his diagnosis? The capital-fuelled inequality is a progressive disease; there are no natural checks and balances to prevent an ever increasing concentration of capital at the expense of those who own nothing but themselves. He questions the failure of mainstream economics to consider the significance of capital-based income and the extreme disparities arising from ownership over generations.

Piketty observes capital ownership conferring advantages over non-owners, tending towards its becoming more concentrated and less widely shared. Through a simple analytic tool, he explains that when returns to capital (e.g. profit) exceed the general increase in economic prosperity, capital concentration increases. This is the general case, the "natural" condition in our modern economic metabolism.

The only significant period where there was a sustained tendency towards equity was during the catastrophic first half of the twentieth century where the mighty forces of two world wars and the Great Depression managed to reverse the trend.

One key accelerator for the progressive nature of this disease is inheritance; given our attempts to democratize society and move away from aristocratic dynasties, this is an unexpected discovery for this twenty-first century doctor.

Not only do those holding capital tend to fare better than others, those with more control do best and all tend to propagate their fortunes through inheritance. Rather than the 10% being compared with the 90%, or the 1% being recently compared with the 99%, consider the 0.1% or even the most advantaged 0.01%; rather than millionaires, think billionaires. The ever more fortuned surge forwards in the wealth race ever more rapidly.

Of course we could simply dismiss Piketty as a French economist keen on swiping at the Anglo-American economic powerhouse and presenting a French vision of an improved world order. However, it would be wise to hesitate for a little while. Then again, his progressive wealth tax could just be another anti-rich socialist policy? Hesitate a little longer.

PIKETTY'S EVIDENCE

Inequality is observed in both income and ownership. Piketty's analysis confirms what may be intuitively hunched; inequalities of capital ownership greatly exceed those of earners. Although today's corporate super-managers earn many times what even professionals can, ownership ranges from vast empires of assets to nothing or even negative assets.

Capital ownership across the world and over time is represented in *Figure 1*. He suggests an ideal, acknowledging that material equality is unrealistic. Next is shown what we may consider as close to ideal, Scandinavia in the 1970's – 1980's. Even here, those of the wealthiest 1% own an average of a hundred times as much as those in the 50% least wealthy; since then Scandinavia has moved towards more inequality.

The Europe of 1910 is shown on right of *Figure 1*, the worst ownership inequality in the modern era. Although historically the US displayed more equality than Europe, this changed during the 1970's and US of today has significantly more concentration of ownership than today's Europe. The trend is for US to reach the inequality levels of Europe 1910, with Europe following more slowly.

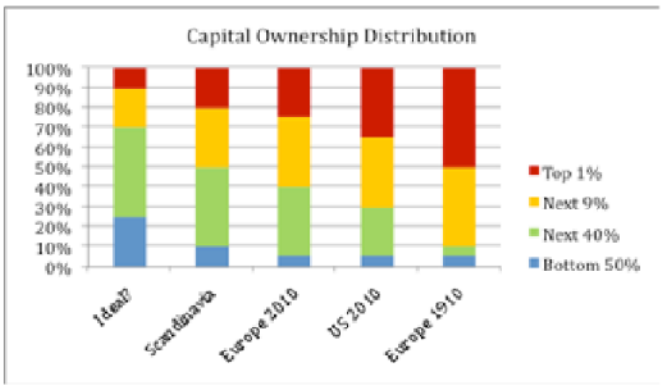

Figure 1: Wealth Distribution across Space and Time (Data from Piketty Table 7.2).

Piketty considers income as combined revenue from capital and earnings from wages; statistics do not make these easy to separate. *Figure 2* illustrates the pattern of inequality relating to income. The model Scandinavia of 1970s – 1980s shows the top 1% earners receiving 7% of the total income share with the lowest 50% earners sharing only 30%.

The Europe of 1910 is now matched by the US, where top 1% US earners share 20% of national income; in contrast, the lowest 50% US earners sharing only 20%. This suggests those at the top have income averaging eighty-three times those in the bottom 50%. The trend suggests significant worsening US inequality by 2030. Today's Europe is significantly more equal than in 1910, but is also trending towards greater inequality.

Piketty acknowledges that such representations can be misleading, but argues that it is impossible to deny that the general levels of inequality are unacceptable, and getting worse. He points out that no person at the top or the bottom of this vast range have different needs in essential daily nourishment, clothing, housing, education, and freedom to enjoy this wonderful world.

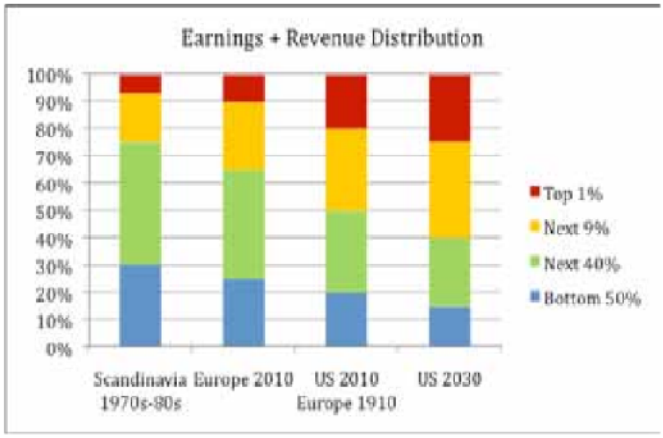

Figure 2: Total Income Distribution across Space and Time (Data from Piketty Table 7.3).

Piketty's examination of the patient's history revealed significant clues for his diagnosis. One finding is illustrated in Figure 3, the change in position of the 1% and 10% European and US wealth-owning elites over time.

Europe experienced inequality earlier in history (much higher European for 1% and 10% in 1810). The founding sense of equality and freedom in the US, a rapid growth in population and lack of an established hierarchical society had tended to moderate extremes of ownership then.

The twentieth century opened with Europe well established in extreme economic inequality; the US was catching up rapidly (see 1910).

Then came one trauma after another, severely disturbing the prevailing constitution. World War One and World War Two together removed the empires of European nations and established the might of US; the intervening Great Depression had removed the gold standard, international trade, and many exuberances of the financial world.

Europe's elites had further to fall and its nations experienced significant war devastation; US was most affected by the Great Depression. Recovery after World War Two was a period of growing equality especially in Europe; wage-earnings surged as the damage was repaired and the new order of Breton Woods prevailed over a soon to be thriving international trade. US was less affected by all this and its elites fared better.

Widespread taxation changes had been introduced after World War One; income tax became significant and "progressive" with

higher rates for higher incomes; wealth tax, mainly as inheritance tax curtailed the tendency of wealth to accumulate in particular family dynasties. These measures supported the relatively equitable period into the 1970's, especially in Europe.

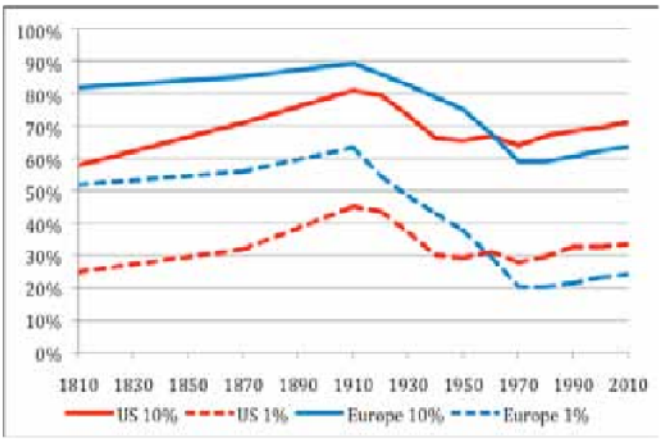

Figure 3: Wealth Inequality in Europe vs. US 1810 - 2010 (Data from Piketty Figure 10.6).

After 1970, an over-stressed financial system forced abandonment of the dollar-gold standard in favour of floating exchange rates. The once egalitarian sense of freedom in the US had transformed into a neo-classical sense of freedom with fewer constraints. Capital controls fell away and the financial world surged forwards, whilst growth in the real economy slowed. Capital ownership regained its supremacy and wealth concentration has been increasing ever since. Old colonial empires had given way to the new financial empires. The brief interlude where equality appeared to be in the ascendance has now faded into the past.

One measure of a nation's capital used by Piketty to illustrate its significance is the number of years of national income would be required to create it (if doing nothing else). Britain's capital base before World War One was seven times national income and a ratio of six was not uncommon amongst European nations. The century turmoil destroyed four years equivalent of national income and it took decades to recover. Good investment involves patience.

Piketty also explains how the once dominant public ownership of capital in the more developed economies has been transferred to private ownership; this can only assist the underlying tendency of capital ownership concentration.

The entrepreneur inevitably tends to become a rentier, more and more dominant over those who own nothing but their labour. Once constituted, capital reproduces itself faster than output increases. The past devours the future.

PIKETTY'S PRESCRIPTION

His unpleasant medicine is an aggressively progressive wealth tax, and this is to be administered as universally as possible. Recognising the patient's reluctance to swallow an intensely distasteful potion, he considers its moderation.

Arguing that capital can easily be exchanged from one type to another (e.g. land ownership to financial assets), such a tax is to be applied to all forms of capital. Capital's free flow across the world necessitates the prescription being applied as universally as possible. Recognising worldwide taxation being near the realm of fantasy, he moderates the prescription to regional applications such as the EU. An annual EU wealth tax applied above a threshold of €1m is suggested; between €1-5m at 1% and at 2% above €5m.

Recognising the patient's reluctance to even accept this, his prognosis is shown to be far worse than the medicine, widespread social disruption and conflict.

PIKETTY HESITATES

Piketty expresses several questions and areas of uncertainty, leaving others to consider them in more depth. He considers the basis on which capital ownership merits payment from the efforts of those engaged in production. Referring to the owner of accumulated capital and the revenue it commands, he asks:

Is it useful and just for the owners of capital to receive this marginal product as payment for their ownership of property (whether their own past savings or that of their ancestors) even if they contribute no new work? This is clearly a crucial question, but not the one I am asking here.

Piketty saw land value as a significant aspect of capital, but unfortunately with a somewhat strict interpretation of land as '*all that nature provides in its natural state*'. Pre-industrial agricultural land falls within his definition but residential and commercial property is excluded. He sought the value of today's "pure land" devoid of any infrastructure or improvement and could not find it. Capital was therefore once dominated by (agricultural) land value, but is now dominated by residential and commercial property value.

Piketty then considers the moral justification for exploitation of capital:

Last but not least, it is important to stress that the price of capital, leaving aside the perennial short- and medium-term bubbles and possible long-term structural divergences, is always in part a social and political construct: it reflects each society's notion of property and depends on the many policies and institutions that regulate relations among different social groups, and especially between those who own capital and those who do not. This is obvious, for example, in the case of real estate prices, which depend on laws regulating the relations between landlords and tenants and controlling rents.

THE FORGOTTEN DOCTOR

Henry George could have comforted and reassured today's doctor. All through his lifelong struggle to convince the unconvincible about natural law and value of land, he broadened and deepened the understanding of a true (i.e. based in natural law) and moral foundation for what had started as a moment's revelation.

Like a flash it came upon me that there was the reason of advancing poverty with advancing wealth. With the growth of population, land grows in value and the men who work it must pay more for the privilege.

This simple yet profound insight allowed George to really start his quest for economic justice. He showed the vital significance of economic rent especially with respect to land, where it came from and the consequences to society of who it went to. His arguments remain worthy of consideration today, as evidenced by occasional appearances in *The Economist*, *The Financial Times* and economists such as Joseph Stiglitz.

The patient appears to be deaf. George hardly whispered; time and time again he explained his diagnosis and prescription in speech and written word across the world. What the patient needed was a simple change in mentality and exercise for full health would be restored. No matter how loud his voice, the patient was either too deaf to hear or too timid to respond.

George clearly saw that private enjoyment of economic rent at the expense of the whole community resulted in progress being necessarily coexistent with poverty. This is the main driving force behind Piketty's observation of ever-greater concentrations of capital or wealth as he defines it.

Economic rent and margin are both fundamental concepts in mainstream economics; yet their relevance to land or location is strangely overlooked. This may be due to confusion or excitement regarding rights to property. George showed in the nineteenth century that location, location, location really mattered and in all ages. The value of any location depends on the value held by the surrounding community of its exclusive occupation or use. One location may be marginal, where the best economic activity can only just support the efforts of workers and supply of real capital. Another location may be more valuable because the same effort and capital yields more than what just supports it. This surplus is the economic rent of that particular location; it obviously relates to the marginal location where by definition there is no economic rent.

George was meticulous in his definition of terms, seeing that so much economic misunderstanding arose from differing usage or understanding of the words being used. Piketty went some way to define terms but perhaps the necessities of his project prevented such rigour.

Capital is a relevant example. George uses the term in what can be said to be a classical economic (not Marxist) sense: '*Capital is wealth used in the process of production, which includes wealth in the course of exchange*'. This obviously excludes 'pure land' but also excludes land in the sense of location, most applicable to urban areas. Contrast this with Piketty who used capital in its financial sense of '*any asset that can be used to make money*'. This brings in private ownership of land, financial assets such as bonds, and even ownership of ideas and shapes; he did at least exclude human capital on grounds similar to George as skills and education are part of the being rather than something to be owned by others in any moral community.

George defines wealth as:

Wealth is all material things produced by labour for the satisfaction of human desires and having exchange value.

This definition is broadly in line with classical economics. Piketty decides not to distinguish wealth and capital and effectively regards them as synonymous.

By explaining economic rent as a natural phenomenon within communities, George shows that there is no natural basis for capital (land) owners to keep it; this answers Piketty's question '*Is it useful and just for the owners of capital to receive [...] payment for their ownership...*' This rent is inherently created by the community and so the natural response is for the communities to use it; hence George's argument for a land value tax. It is what Piketty calls '*social and political structures*' that allow economic rent to be retained in private hands; it is this that accelerates the anything-but-great divide between the wealthy and poverty-stricken.

Piketty could not see '*pure land*' and hence dismissed land as having relevance today. George's revelation may well have been of payments for the privilege to use '*pure land*', but the principle remains even under the invaluable real estate in the great city centres. People are prepared to pay for a site, replace any buildings with what the market most desires, and rent or sell the result. The '*pure land*' value is the *'residual value'* familiar to developers; if the final sale or rental price exceeds the total cost of demolition and rebuild, this is the value of the land or location itself; it is the economic rent of land.

Piketty wanted a wealth tax to be applied to all forms of wealth in his terms. George would take issue with this and argue for only applying the tax to land value. For Piketty, land value is a form of wealth but to George it is not wealth; hence George would always reject the wealth tax and yet support land value tax.

In this way, taking a second opinion from Henry George would have greatly helped Piketty's valuable work.

For anyone to invest their energy in pursuing the questions that life presents them, to overcome all challenges and then expressing what was discovered for all to see is worthy of praise. Smith, George and Piketty are notable amongst many who have tried.

Smith remains the Grandfather of economics as we know it. He overturned great misconceptions and shone a light over the possibilities of capital accumulation and free markets. For those who had not read his work, *Theory of Moral Sentiments,* there could have been a gap in understanding as epitomised by neoclassical economic thought; the result has been exploitation of the free market leading to the very mixed global experience of today. Not only has capital accumulated, but so has inequality; there has also been an accumulation of misconception about Smith's vision.

Piketty's grand vision, perhaps more of a hope, is in the potential of a democracy to re-establish order based on equality and meritocratic principles. As a community we aim towards a better world for the whole, and look after those not able to look after themselves. Hence he argues that inequity-creating capitalistic forces are undemocratic. Rather than the deserving being rewarded, it is those at the top. Capital has no morals, whilst democracy is based on morals. This sick patient needs to decide to get better. This decision is a democratic one, and democracy needs to assert itself against the potential tyranny of concentrated capital.

Henry George had a depth of insight into natural and moral law that may not have been so available to Smith and Piketty. From the moral standpoint he can answer Piketty's questions. From his standpoint of the natural laws of economics he can show how a '*wealth tax*' can be equitably applied, how it is not really a '*tax*' nor on '*wealth*' but a return to the community of what arose from the community. With such a measure, Piketty's inheritance accelerator to inequality would evaporate.

We are a very sick patient. Our first challenge is to acknowledge our condition and seek help; our second challenge is deciding on the best doctor; our third challenge is to heed the advice and swallow the medicine. What will we do?