Piketty’s Missing Entrepreneurs

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You might think that there is nothing left to be said about this year’s liberal darling liber, Capital in the Twenty-First Century, but Piketty’s opus has just been named the Financial Times’ Business Book of the Year, not so long after that same publication also questioned a variety of Piketty’s empirical conclusions.

It turns out the FT hardly exhausted the problems with Piketty’s data. One issue that has not been discussed at length: the French economist’s work on the source of wealth in the United States.

Affluent Americans, Piketty believes, broadly belong to two main categories. “Rentiers” have inherited wealth and live off the capital returns of their dynastic fortunes, while “supermanagers” are salaried corporate executives whose pay has grown spectacularly by negotiating large compensation packages.

There is one problem with this categorization: It’s wrong.

Even accounting for the fact that economic models simplify things, Piketty has misunderstood the American data and cites the relevant research on top earners incorrectly.

Wealthy rentiers and salaried corporate executives may be vaguely unsympathetic groups, but they do not constitute the bulk of rich Americans. In particular, Piketty underestimates the importance of entrepreneurs and business owners.

It’s not a minor oversight: Self-employed business owners who actively manage their firms own around 70 percent of the wealth of the top 0.1 percent. With top earnings, too, business owners are far more important than salaried executives. This doesn’t change the fact that inequality is high and rising, but it undermines Piketty’s explanation for why inequality is increasing in the United States.

While the exact magnitude is debated, Piketty is indisputably right that economic inequality has increased rapidly. According to the Congressional Budget Office, the pre-tax income share of the top 1 percent increase from an already high 9 percent in 1979 to 15 percent in 2010. I sympathize with Piketty’s concerns and entirely agree that the explosion of income disparity that we are witnessing is problematic for society. According to the CBO, real median incomes increased by less than 40 percent between 1980 and 2010, while earnings of the top 1 percent tripled.

Decades of middle-class stagnation was hardly what the adherents of the Chicago school were hoping for. The economy is not a zero-sum game, but nor is it an infinite-sum game. With competition for status, positional goods, mates, and permanently scarce real-estate, both absolute and relative income influence well-being.

So what is Piketty getting so wrong? Economists’ standard theories on rising inequality include skill-biased technological change, globalization, financialization, tax cuts for the rich, low-skilled immigration, and winner-take-all-markets.

With the exception of tax cuts, Piketty rejects these causes. He is particularly hostile toward explanations focusing on higher returns to skill, which he believes “legitimize” inequality.

Instead, Piketty’s controversial “r > g” theory views capital concentration as the fundamental force in capitalism. Piketty believes that most top wealth is inherited and that the rich tend to pass on their growing wealth to the next generation. It goes like this: Assume that the wealthy receive a return of 6 percent of their capital, spend half and reinvest the remaining 3 percent perpetually while the growth rate of the economy is 2 percent; the fortunes of the rich will outgrow the economy by 1 percent per year and eventually take over the economy.

But Piketty is aware that the force driving his r > g theory — rentiers with ever-growing inherited fortunes — is ill-suited for the United States. The book therefore introduces a second force behind inequality to better account for trends here. Piketty believes that most top earning Americans are senior managers of large firms, a group that he labels “supermanagers”:

The increase in very high incomes and very high salaries primarily reflects the advent of “supermanagers,” that is, top executives of large firms who have managed to obtain extremely high, historically unprecedented compensation packages for their labor. One possible explanation of this is that the skills and productivity of these top managers rose suddenly in relation to those of other workers. Another explanation, which to me seems more plausible and turns out to be much more consistent with the evidence, is that these top managers by and large have the power to set their own remuneration, in some cases without limit and in many cases without any clear relation to their individual productivity, which in any case is very difficult to estimate in a large organization.

One of Piketty’s central arguments is that the earnings of corporate executives are not determined by market forces but through bargaining in hierarchical organizations. Social norms, corporate politics, corruption and nepotism by “hierarchical superiors” determine what supermanagers are paid. The transfer of hundreds of billions of dollars in these negotiations, Piketty thinks, has caused stagnating middle class incomes and rising top incomes without contributing to growth. In Piketty’s view, rich Americans have raised their incomes through rent-seeking rather than value creation.

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