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Piketty and the Gilded Age

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After Thomas Piketty's *Capital in the Twenty-First Century*, comparing our era to the Gilded Age is no longer just a metaphor: Piketty argues that we never actually left the Gilded Age.[1] The mid-twentieth-century period of lower inequality was a massive and perhaps unrepeatable exception to what Piketty sees as the natural tendencies toward inequality inherent in capitalist societies. But comparing our current period of relentless cuts in taxes and rising inequality to the Gilded Age shows why our period cannot be a repeat of the Gilded Age: the Gilded Age itself led to so many transformations to capitalism that inequality no longer leads to the political outrage that could anchor a broad-based progressive movement. The Gilded Age led to policies that made capitalism bearable, and that is precisely what is leading now to a situation in which Americans identify their success with the free market, and resist policies to lower inequality.

Let's start with Piketty. Piketty's basic argument is that when the rate of return to capital is greater than the rate of economic growth, inequality will rise. At mid-century, war and the aftershocks of war increased economic growth but lowered the rates of return to capital in both Europe and the United States. The wars destroyed physical capital and much of what was not destroyed was nationalized, while low savings rates and asset prices, not to mention the Great Depression and inflation, decimated capitalist returns. The consequence was egalitarianism. But once economies recovered from those mid-century shocks, they reverted to a pattern of higher rates of return to capital and lower economic growth: thus, Piketty's famous U-shaped charts showing income and wealth inequality rapidly declining until 1940, then stable until the 1970s, and then rising rapidly after 1980. Piketty then draws out his equation and uses it to forecast trends for the rest of the century, suggesting wealth and income disparities could return to levels last seen in Europe in the eighteenth century, because economic growth will be even lower and returns to capital even higher.

For all of the seeming economic determinism of this model, in fact, Piketty throws in quite a lot of contingency and politics along the way. He blames the unusually high inequality of the United States on the structure of executive compensation, but this is seen only in the United States and is not a universal dynamic of capitalism. He mentions privatization, unusual rises in stock markets and real estate prices, and the scaling back of tax rates. None of these is given in the model; these are all factors exogenous to it. Even his major long-term variables causing slower economic growth—demography and technology—can be altered with policy.

Examining the origins of some of these more contingent factors can help to answer whether current levels of inequality are truly inevitable. This essay focuses on taxation,

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as tax changes can affect inequality both directly, altering the distribution through taking from some; and indirectly, by financing policies to give to others. The discussion here draws on my book *Starving the Beast* (2018), and readers are referred to the book for details and supporting evidence.[2]

The United States has seen a four-decade-long movement to cut back taxes; indeed, cutting taxes has, as a policy, taken over and transformed the Republican Party. At mid-century the Republican Party was committed to balanced budgets and hesitant to cut taxes. Starting in the 1970s, however, a tax cut movement gained ground within the Republican Party. Its first victory was the Economic Recovery Tax Act of 1981 under President Ronald Reagan—the famous "Laffer curve" or "supply side economics" tax cut, the largest tax cut in American history. However, it quickly became clear that the ERTA would increase deficits, and the very next year Reagan increased taxes, netting out to a modest tax cut of a size that had been called for from across the political spectrum. Reagan would not attempt to cut taxes so radically again, confining himself to a revenue-neutral tax reform in his second term.

The Republican Party rediscovered tax cuts in the 1990s partly because George H.W. Bush's loss in 1992 was widely interpreted—rightly or wrongly—as a referendum on his broken promise not to increase taxes. Several governors began to experiment with offering tax cuts. This was in general a time of Republican electoral success at both state and congressional level in many states, and although there are many factors in this realignment—including the Southern states slowly abandoning the Democrats for racial reasons—tax cuts were seen by Republicans as an issue with electoral potential.

It was in this context, with Republican activists and state- and local-level policymakers increasingly organized on the issue of taxation, that George W. Bush implemented a series of tax cuts in his two terms in office. Once again, those tax cuts produced deficits, but this time, the administration did not back away from them. What had happened in the interim is that the political world had discovered that foreigners were willing to finance American deficits. This meant government deficits did not crowd out private sector borrowing and did not raise interest rates as had traditionally been feared. And once the markets were no longer afraid of deficits, voters, it seemed, were no longer afraid of deficits. Although when specifically asked about the deficit a strong majority of voters expressed concern, they did not seem to vote in accordance with that concern. Thus, neither markets, nor voters, punished politicians for deficits. The tax cut of 2017, the only significant achievement of the current administration, is a result of this dynamic.

Piketty himself, and many of those who read him, are convinced that capital must be behind this shift in policy. After all, it stands to reason that if capitalists benefit from tax cuts, they must have pushed those tax cuts. But business interests opposed the main part of Reagan's policy, and Reagan had to convince them to support it by promising them a separate, smaller tax cut for capital. George W. Bush also had to work to get business to support his tax cuts. Business interests feared these tax cuts because they feared the deficits they would lead to. Business interests were more prominent and influential in the 2017 tax cut, having gotten over the deficit fears; but they were not at the origins of the tax cut movement, and have only recently jumped on the bandwagon.

There is not much support for the argument that tax cuts are a more palatable form of racism, a way to appeal to voters who don't want "our" money going to "them." There is evidence that racist white voters were more supportive of Reagan's tax cut

than other white voters, but on the other hand, black voters were just as supportive of the tax cut as white voters.

Some historians have emphasized new intellectual currents, such as the group of academics loosely affiliated with the Mont Pèlerin Society. But this is not where the idea for tax cuts originated. Although Milton Friedman eventually came to support Reagan's tax cut, it was not Friedman's plan—his preferred tax policies were things like a flat tax or getting rid of inheritance tax.[3] But what Reagan implemented were large, across-the-board cuts in individual income tax. Nor were most economists supportive of the proposal, with the Congressional Budget Office under Alice Rivlin casting doubt on Reagan's optimistic assumptions.

To explain the origins of the tax cut, we have to begin with where the Republican Party was in the mid-1970s, after the drama of Watergate. With a few short exceptions, Republicans had not controlled Congress for almost forty years. Several generations had come of age with Democrats in power, so that it seemed almost natural for Democrats to control Congress. Two Republicans had been elected president over that period, but even that proved to be a mixed blessing in the wake of Watergate. Republican Party affiliation dropped to new lows, and analysts talked openly about the possibility of the party going extinct.

The problem for the Republicans was that although Americans claim not to like government, in practice, Americans love every specific thing that government does.[4] They particularly love the specific programs that make up the welfare state that Democrats had built. When pollsters ask which government programs should be cut, the only programs that prove to be unpopular are very small ones, such as foreign aid. Even "welfare" is not really unpopular if it is called "aid to the poor." Americans don't want to cut Social Security or Medicare, certainly; and the ones who hate government generally are not the ones who want to cut defense spending. Add in interest on the debt, and 70 percent of government spending is essentially untouchable. The other 30 percent is not much easier to cut, as it includes everything from spending on veterans to infrastructure to scientific research and development. Thus, Republicans who want to reduce the size of government have their task cut out for them. This was the secret to the longevity of the New Deal coalition. For four decades, Roosevelt's New Deal coalition locked Republicans out of power in Congress.

Republicans got their chance to break through when inflation shook the American consumer economy in the 1970s. As the price of homes, home loans, gasoline, and everyday goods climbed, Americans were also hit by rising taxes. Higher property taxes raised the value of homes and thus the burden of property taxes, generating a series of taxpayer revolts that brought political attention to the issue of tax cuts. And because nominal wages rose to keep pace with rising prices, taxpayers found themselves in higher federal income tax brackets even though wages in real terms were not much higher—the phenomenon of "bracket creep." These issues led to polls showing peaks in the percentage of Americans responding that taxes were too high.

It's not exactly the case that Americans were clamoring for federal income tax cuts, and there was never really the widespread revolt against federal income taxation that Republicans fantasized about. There were tax revolts, but those were located at the state level. And when pollsters asked if respondents would prefer lower taxes if they came at the cost of spending cuts or budget balance, strong majorities responded no. But there was enough grumbling and disquiet about taxes for Republicans politicians to forge a path. The narrow electoral path that Republicans built, the path that could get them out of their post-Watergate doldrums, was to convince voters that tax cuts

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would not lead to spending cuts or deficits, because so much money was being wasted by government. It was a remarkably effective electoral strategy. Whereas for decades voters had considered Democrats more likely to generate prosperity, after 1980, the Republicans' message of low taxes brought them to parity.

None of this sequence is purely contingent. American tax structures were more vulnerable to inflation than the tax structures of many other countries, for example, and this was an outgrowth not of contingency but rather the division in early twentieth-century politics between an agrarian Midwest and South on the one hand and an industrial Northeast on the other. The Midwest and South ganged up to place high tax rates on the wealthy, who were mostly those in the Northeast. That progressivity in the tax structure would, decades later, allow bracket creep, in ways that were not seen in countries where regressive sales taxes played more of a role. Nor is there anything contingent about the popularity of the New Deal model and Republican efforts to break through. Nor is there a mystery about why this happened after 1980 and not before: Reagan's deficits showed that deficits could be financed with international capital. Thus, voters did not punish politicians for deficits Thus, politicians stopped worrying about deficits.

If none of these different sequences of events is contingent, the interactions between them are so complex and chaotic that it is impossible to discern inevitability anywhere here. Things could have gone down different paths at so many points in the story. And what the story clearly shows is that the rise of the tax cut movement is entirely political. Although it was precipitated by economic crisis, it neither resolved the crisis—it was ultimately the actions of the Federal Reserve that controlled inflation—nor was necessitated by the crisis.

Ultimately, the Republican triumph is a political one, not a matter of economic inevitability—the Republicans hit on a formula that got them votes. It's possible to blame Republicans for exaggerating the extent of waste, fraud, and abuse in government spending, and therefore for misleading voters into thinking that tax cuts are less costly than they actually are. But that would be holding electoral politicians to a very high bar, one that was not demanded of New Deal politicians promising welfare benefits, the economic consequences of which were not always clear. To the extent that inequality continues because progressive taxation is being unwound, part of the reason for inequality is that the message of low taxes resonates with Americans.

If the issue is political, can the tax cut movement be reversed? Here the equivalence with the Gilded Age falls down. If this story belies the strong determinism of the Piketty model, there is one factor that suggests how difficult it may be to return to the era of egalitarianism: precisely that we are living in a world shaped by the Gilded Age, in that many of the policies that emerged during the Progressive Era and the several decades that followed have removed the extreme vulnerabilities created by unfettered capitalism. American politics are extremely volatile today, but part of the perennial puzzle of why Americans don't vote to reduce inequality is that the policies and instruments that came out of the first Gilded Age and the longer-term developments of the 1950s and 1960s have made capitalism bearable for most people. Indeed, the vigorous and decades-long conservative movement, although it has often been successful in preventing the further expansion of the state, has not actually managed to roll back the state—not to the Gilded Age, not even to before the New Deal, not even to before the Great Society. This means that the urgency of the Progressive Era is also missing, and many Americans identify their prosperity with the free market, and therefore with lower tax cuts. Social Security, Medicare, Medicaid, and the patchwork of American programs, inadequate as they are when compared to the robust welfare states of Europe,

free the middle classes to think about things other than economics. Americans tell pollsters that they do not like inequality, but they do not vote based on that preference. What concerns voters in the voting booth is absolute wage stagnation, not relative levels of income or wealth. Until and unless the policies the Gilded Age and the next half century gave us are scaled back, we will not go back to either the extremes of desperation, or the conflict and progress, that came out of the Gilded Age. This suggests a long-term *political* dynamic under capitalism that is worth considering even if the long-term *economic* dynamics are open: inequality may in fact rise in the long run, but inequality may mean less to voters if absolute income levels are also rising, and a core of welfare state programs prevents mass poverty and vulnerability.

Notes

1 Thomas Piketty, *Capital in the Twenty-First Century* (Cambridge, MA: Harvard University Press, 2017).

2 Monica Prasad, *Starving the Beast: Ronald Reagan and the Tax Cut Revolution* (New York: Russell Sage Foundation, 2018).

3 See, for instance, Angus Burgin, *The Great Persuasion: Reinventing Free Markets since the Depression* (Cambridge, MA: Harvard University Press, 2012), 180.

4 Matt Grossmann and David A. Hopkins, *Asymmetric Politics: Ideological Republicans and Group Interest Democrats* (Oxford: Oxford University Press, 2016).

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