As a result, let's think about Piketty's argument in its full sense. If changes in social norms have allowed remuneration of top employees to rise, there must have been a sufficient surplus generated to pay them that. If the government now lifted the marginal tax rate of high incomes to confiscatory levels, we would see income inequality fall and top wages decline. However, given social norms, we would also see a significant increase in other forms of remuneration—and in ways to remunerate these employees that are not subject to tax. In what ways has the fundamental imbalance in terms of the claim on resources changed here? Yes, we will have nice lower income inequality statistics to show off, but any actual change in remuneration would be down to greater deadweight loss from taxation as firms and superstar employees use inefficient ways of avoiding tax.

Piketty's decision to just assume that high marginal tax rates will change social norms is an unsatisfying, unjustified assumption—and it is the basis of his recommendation for confiscatory income taxes for high incomes.

Even accepting that the voluntary agreement between a firm and its manager to pay 'excessive' wages is unjust, Piketty's solution of confiscatory taxes—which is akin to setting a maximum pay rate—simply does not follow. Instead, we need to ask about the institutional design of firms such that shareholders are paying such significant salaries to supermanagers instead of keeping the earnings for themselves, and why this may matter.

Summing up

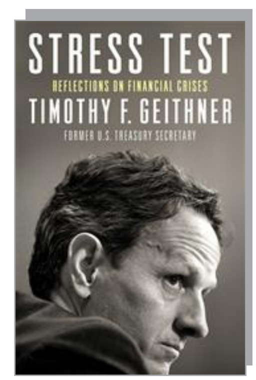
Capital in the Twenty-First Century is an important book. It highlights the impressive data pulled together by Piketty and other authors who followed his lead. Furthermore, it provides a framework to give the data meaning.

However, the policy conclusions of confiscatory tax on high incomes and a progressive tax on capital stand on far shakier ground than Piketty discusses in his book—relying on an empirically false assumption about the elasticity of substitution between labour and capital, strong moral judgments on what is fair, and an obfuscation of some of the real costs associated with his policy prescriptions.

In an ideal world, Piketty's insightful data work will spur economists to understand more about the changing distribution of income and what it means for the welfare of individuals in a society—but not to an acceptance of his hard-to-defend policy prescriptions.

Reviewed by Matt Nolan

Stress Test: Reflections on Financial Crises [Kindle Edition]



By Timothy F. Geithner
Crown, 2014
US$9.12, 592 pages
(Kindle edition)
ISBN 9780804121187

When government financial officers, like Treasury Secretaries and Fed Chairmen, stand at the edge of the cliff of a market panic and stare down into the abyss of potential financial chaos, they always decide upon government intervention. In the first place, nobody wants to go down in the ignominy of being the ones who stood there and did nothing in the face of a financial collapse. Secondly, nobody will or should take the risk of triggering the unnecessary financial and economic destruction of a debt deflation. So they always do and should intervene.

In a panic, the desire for return on capital is replaced by the desire for return of

> capital (as Will Rogers said), uncertainty premiums grow extremely high, and everybody wants a government guaranty. To supply the market with the government guarantees it craves, government balance sheets intermediate between the panicky market's excessive demand for safety and risk assets. Their expansion allows private balance sheets to reduce risk. It should always be temporary and limited to the crisis.

I wrote the above lines in March 2008. It was true of Hank Paulson, Ben Bernanke, and Tim Geithner at that time. It is true of all governments in all countries in all times. No responsible officers are ever willing to go down in history as the ones who just stood there. Put in their position and faced with the same intense uncertainty and pervasive fear, you would make the same decision.

Governments typically go through three phases when faced with a financial crisis. First, there is delay in realising the extent of the losses while issuing later-embarrassing public assurances. Second, the central bank acts as lender of last resort, following Walter Bagehot's classic advice to the Bank of England for dealing with panics. Then it is realised that large swaths of the financial sector are not only illiquid but also broke, and they need not just loans but also more equity. The government as investor of last resort provides equity in one form or another. It is always objected that these interventions create moral hazard (long-run weakening of discipline), and so they do. But the threat of immediate financial collapse trumps the objections.

The preceding four paragraphs sum up the intellectual argument and the outline of the events covered in the 500 pages of *Stress Test*, by Tim Geithner, former secretary of the US Treasury, and before that, president of the Federal Reserve Bank of New York. In these positions, Geithner was a principal actor in shaping and carrying out the government's many and massive interventions during the financial crisis of 2007–09, as well as the inevitable political and regulatory overreaction afterwards.

In this crisis memoir, he is determined and eager to defend and fully justify the interventions and bailouts in which he played such a prominent part. Fair enough. But the basic argument is repeated what comes to seem like dozens of times, as is the dismissal of those who objected to the interventions as 'Old Testament moral hazard fundamentalists.' The book is tendentious, and as far as the fundamental intellectual proposition goes, repetitious.

Nonetheless, it is a good read, very interesting and enjoyable. This is because of the intensely first person insider experiences it relates, numerous colourful personalities, the conflicts and disputes, the doubt and fear, the fall and crash of formerly famous institutions, the unhappy surprises, the desperation, the anger, the hope, and finally, surviving the crisis. It is a good story, nice and gossipy, quoting lots of private remarks and conversations, and quite emotional—the financial crisis as melodrama, or perhaps, as soap opera.

Stress Test vividly expresses the extreme uncertainty facing decision-makers in the midst of a financial crisis. There is 'the fog of uncertainty,' and 'making life or death decisions in a fog of uncertainty, dealing with the constant risk of catastrophic failure' when you do not and cannot know what the results of your actions will be. 'The uncertainty of waiting for the stress test was agonizing ... The President asked me, "Tim, Are you sure your plan is going to work?" I said no.' There is also the 'fog of diagnosis,' the huge difficulty of knowing what is really going on and how big and where the losses are. 'No one would know who was safe.' 'No one in the room could be sure their firm would survive.' 'We were in uncharted territory.' 'Manias are inherently unpredictable.' 'Human interactions are inherently unpredictable.' While the crisis lasts, you cannot get out of the fog.

Geithner correctly observes how hard it is to imagine how bad things can get in a crisis, how much worse than your worst-case scenario the reality may become. Considering the many 'failures of foresight' of the financial regulators, he reflects, 'Our crisis was largely a failure of imagination. Every crisis is. For all my talk about tail risk ...

we didn't foresee how a nationwide decline in home prices could induce panic.' 'I got to see how much power the belief in the "Great Moderation" had over smart people … the widespread belief that devastating financial crises were a thing of the past.' 'We certainly could have been more prescient … But we were human.' You 'cannot depend on omniscient supervisors.' That's for sure: There were not and will not be any of those.

Uncertainty and, therefore, surprises force improvisation. Henry Paulson, Geithner's predecessor as Treasury secretary, said of the crisis, 'We had no choice but to fly by the seat of our pants, making it up as we went along.' Geithner says they were 'lurching': 'The U.S. government as a whole fell too far behind the curve of the panic, lurching from emergency to emergency, averting disasters with duct tape and ad hoc authorities.' 'We were lurching from emergency to emergency without a comprehensive plan.' 'Our constant zigzags looked ridiculous. We were lurching all over the place, and no one had any idea what to expect next.' Meanwhile, 'Foreign governments and other investors … were screaming for U.S. government protection.'

This brings us to dramatic emotions, for example, 'crushing fear and nausea': 'I remember in August [2008] … I pulled off Interstate 95 at an exit in Warwick, Rhode Island, to finish a call … I don't remember the conversation—it's lost in the fog of war—but whenever I drive past that Warwick exit, I get a wave of the same crushing fear and nausea I felt that summer.' On becoming Treasury secretary: 'It felt dark and daunting.' 'Ever since high school, I had dreaded public speaking … The run-up to my speech was horribly tense … My inept delivery and lack of detail … My public debut had been an unmitigated fiasco.' 'If you weren't traumatized by the fall of Lehman and terrified by the thought of another Lehman, you weren't paying attention.' 'It's hard to describe the stress.' 'You know things are dark when you have to convene a 3 a.m. conference call.' 'Anyone who wasn't scared had no idea how close we were to the abyss.' 'The pace was frantic, the pressure overwhelming. I was worried the world was coming to an end.' 'It was a horrible feeling. I tried not to be paralyzed by it or sit around whining … the paralyzing risk of catastrophic failure … the uncertainty … the pain and guilt … the loneliness and numbness … the terror of those days.' 'I had never felt this kind of dread.'

The emotions verge on self pity: 'I'm sure a lot of the public saw me as that hapless, cowed-by-the-banks caricature.' 'I had been portrayed throughout my confirmation as a tax cheat.' 'I already felt crushing guilt about the humiliation I was forcing on my family.' 'One meeting … devolved into psychoanalysis, with various colleagues offering theories about how the crisis had warped me.' 'We could expect withering attacks no matter what we did.' 'I don't think the public ever really got to know me.'

Geithner's story has the *dramatis personae* required for a good soap opera. The embattled protagonist, of course, himself. Some stalwart heroes: Hank Paulson and Ben Bernanke. A wise counsellor, Bob Rubin, often consulted in spite of his close association with the teetering Citigroup. (The call from I-95 was to him.) Loyal supporters—the New York Fed and Treasury staffs. A witty, intellectually dashing Mercutio to Geithner's anguished Romeo, Larry Summers, impressive at deflating everybody else's arguments. And many hateful villains: all Republicans except Paulson and Bernanke (and except President Bush when he supported TARP). It is these villains who create the 'backbiting and posturing and political gamesmanship in Washington'; 'all kinds of unnecessary obstacles in the way'; and 'the steady stream of absurdity emanating from Capitol Hill.'

Geithner does not like politics and was much more comfortable as a behind-the-scenes mandarin than a public figure, and would prefer bureaucrats, not politicians, running the show. He does not like 'the soul-crushing pathologies of Washington,' the 'selfishness and grandstanding, shameless hypocrisy and mindless partisanship.' Yet this is a thoroughly and intensely partisan book.

It is a book entirely loyal to President Obama, although a few discords are portrayed. The president is shown as overpromising—and thereby setting up for possible failure—Geithner's disastrous first speech as Treasury Secretary. Obama then proclaims when everybody is outraged by the bonuses paid at the bailed out AIG that 'I want everybody to be clear that Secretary Geithner has been on the case.' But the case was hopeless. So, says Geithner, 'I didn't see the need to remind everybody that I was on the case.' Finally, Geithner reports that at a White House Correspondents' Association dinner, Obama 'quipped' that 'one of his goals for his second hundred days in office would be to housetrain his new dog, Bo, so that he wouldn't treat me like a fire hydrant.' Could you really forgive that one?

Never mentioned in the book is the fact that the government itself can induce great risks, and indeed, was an important cause of the 2007–09 financial crisis. There is no mention of the Clinton administration's promotion of 'innovative' mortgages—that is, riskier mortgages with lower credit standards. Never mentioned is how the Federal Reserve stoked the housing boom in 2001–03 to try to promote a 'wealth effect,' and thereby, puffed hot air into the housing bubble. Somehow never mentioned is that the egregious Fannie Mae and Freddie Mac were creatures and designs of the government, which while borrowing on the Treasury's credit card, inflated the bubble on a hyper-leveraged basis. Or that the government's deposit insurance promotes high leverage.

This inability to see the major systemic risks created by the government is not only a lack in Geithner's crisis melodrama, but also a signal failure of a significant political offspring of the crisis, the FSOC (Financial Stability Oversight Council). The FSOC will never successfully deal with systemic risk if it cannot deal with the risks created by its own member bureaucracies—especially, but not only, by the Federal Reserve.

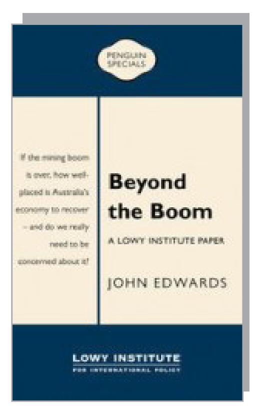
Also never included for comparative analysis in *Stress Test* is the great financial crisis of the 1980s, which resulted in the 1982–92 failure of more than 2,200 US financial institutions. 'The American financial system is being held together only by government guarantees,' I wrote in my journal on 27 August 1989. But then Geithner, who was born in 1961, was only in his 20s for that crisis. After the 'Reform, Recovery and Enforcement' legislation at the end of the 1980s, then-Secretary of the Treasury Nicholas Brady proclaimed, 'Never Again.' But only 20 years later the 'Again' came, and his successor, Geithner, was dreading a financial collapse.

Much to his credit, Geithner does not make the same mistake of thinking that 'Never Again' has been achieved. 'Experts always have clever reasons why the boom they are enjoying will avoid the disastrous patterns of the past—until it doesn't,' he reflects. 'There will be a next crisis, despite all we did.'

I believe he is right about that. After the memories fade, which takes only 10 years or so, and the now best-selling books about the crisis are no longer read, there will be another crisis. There will then be another set of government interventions. And more memoirs afterwards.

Reviewed by Alex J. Pollock

Beyond the Boom: A Lowy Institute Paper



By John Edwards
Penguin, 2014
$9.99, 176 pages
ISBN 9780143572183

John Edwards' *Beyond the Boom* is a welcome follow-up to his *Quiet Boom* (2006), which I reviewed at the time in conjunction with Ian Macfarlane's Boyer Lectures (see Stephen Kirchner, 'Two Views on the Economic Expansion,' *Policy* 23:2 (2007).

I agree with his overall argument that economic reform should not be sold on the basis of a faux crisis