Piketty's Rickety Assault on Capital

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Capital in the Twenty-First Century, by Thomas Piketty, translated by Arthur Goldhammer (Cambridge, MA: Harvard University Press, 2014), 696 pp. $39.95 (hardcover).

Thomas Piketty's *Capital in the Twenty-First Century* makes an important contribution to the economic history of industrialization since the early 18th century. His collection of data on the distribution of income and wealth around the globe, drawn mainly from tax records, surveys, and national reports, is rigorous and comprehensive; no one before has collected such credible material in this important sub-field of economics. Piketty is also to be credited for presenting the data in scores of easy-to-interpret graphs and for making it available online for those wishing to verify the presentation and/or investigate alternative empirical patterns.

Capital has five main parts: empirical history, financial-economic relationships in algebraic form, predictions for the century ahead, a defense of political economy, and policy advice. The book title is misleading, for Piketty doesn't truly examine "capital in the twenty-first century" (other than predicting that "potentially" capital will "over-accumulate" if "under-taxed"). Rather, he examines shifts in inequalities of income and wealth during the 19th and 20th centuries, selecting five nations rich enough to warrant study (and where reliable data exist): Britain, France, Germany, the United States, and Japan.

Capital purports to show that unrestrained capitalism leads to ever-increasing income inequality and to the destruction of the liberal political order, and that the only solution is for government to engage in far more intensive efforts to forcibly seize the wealth of people who have "too much." Piketty tries to provide

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an empirical-scientific justification for the egalitarian, welfare-statist aims that have been pushed with increasing intensity in recent decades (in reaction to the Reagan-Thatcher policies of the 1980s and 1990s). Piketty's assertions echo the sympathies long felt by left-wing academics, reflect the Pope's claim that economic inequality is "the root of social evil,"[1] and dovetail with Barack Obama's insistence that economic inequality constitutes "the defining challenge of our time."[2]

The vast compilation of historical data in *Capital* does not explain why it sold eighty thousand copies in its first two months;[3] nor why, in the words of the *Economist*, it is "the economics book taking the world by storm";[4] nor why scores of publications have released reviews by so many writers who haven't read the book.[5] *Capital* was an instant best seller and is being widely touted because it affirms prevailing biases against unequal wealth in particular and capitalism generally, especially among leftist intellectuals (and even a few conservatives), many of whom praise the book glowingly while interpreting it superficially.

Piketty makes it easy for cursory reviewers to comment quickly and superficially on his long, quantitatively dense book, by summarizing its assertions in an introduction loaded with sweeping, easily digestible verbiage. Many reviewers can be found importing these summations, almost verbatim, into their text. Surely, a book of such influence deserves, instead, a thorough, objective analysis.

Although many people from various political perspectives have reviewed the book, few have questioned Piketty's assertion that economic inequality is unjust. Marxist David Harvey complains that *Capital* doesn't adhere closely enough to Marxian doctrines, but he is pleased that Piketty "demolishes the widely-held view that free market capitalism spreads the wealth around."[6] Keynesian Nobel Laureate and *New York Times* essayist Paul Krugman calls it "a magnificent, sweeping meditation on inequality," "truly superb," and "awesome."[7] Academia's top newspaper had *Capital* reviewed by an English professor (an unlikely expert in economics) who eagerly declared that Piketty's data set "allows him to deliver a devastating blow to the confidence of many economists that capitalism is a tide that gradually lifts all boats."[8] Professor Tyler Cowen of the market-friendly George Mason University sympathizes with the book's anticapitalist tilt, admires how it "attempts something grander than a mere diagnosis of capitalism's ill effects," yet wishes Piketty had offered "a more sensible and practicable policy agenda for reducing inequality."[9] Many of today's "bleeding heart" conservatives and libertarians, who suspect that inequality of income and wealth is somehow unjust, merely quibble about Piketty's sources, definitions, math, and tangential

literary references,[10] and debate whether his call for massive new tax hikes on those with large incomes or net worth would actually help society's "least advantaged."

The nearly critique-free reception for *Capital* resembles that of an earlier, highly praised tome by the late John Rawls of Harvard (*A Theory of Justice*, 1971), which asserts that inequality of wealth and opportunity is never morally justifiable unless it benefits society's poor or "least advantaged." Not coincidentally, Piketty relies explicitly on Rawls's illiberal, egalitarian premises (pp. 480, 575), and seeks to do in economics what Rawls sought to do in politics: to put forth an argument that refutes capitalism on principle. Piketty knows that Rawls's egalitarian standard (the "difference principle") must permit *some* economic inequality, in part because one can always class groups as "poor" and "least advantaged" in relative terms even if all people generally grow richer. And, like Rawls, Piketty embraces a political ideal necessitating a coercive redistribution of wealth.

Addressing Distribution while Ignoring Production

Despite its better elements, Piketty's work is profoundly flawed, in that neither his data nor his logic supports his economic, political, or ethical claims. The fundamental error in Piketty's book is not that he focuses mainly on the distribution of income and wealth, but that *he severs distribution from production*. Distribution obviously is a legitimate field in political economy; it entails the question of who receives income and wealth, plus how and why they do so. But to study the *distribution* of wealth while ignoring the *origin* of wealth is to err badly, especially when it is recognized that people (and firms) are paid *when and as* they produce and trade. The correct distribution of wealth is inextricably linked to the creation of wealth.[11] Absent force or fraud (and apart from charity), people and firms receive economic value from others in exchange for economic value they first produce. In a free market, economic values are created and exchanged voluntarily for other economic values. Even when a person gives someone a gift, he can do so only if he first has produced the good or produced some value with which to trade for it. Piketty ignores or derides the crucial link between production and distribution.

His treatment of income and wealth distribution is further flawed by being overly aggregated in arbitrary classes (the "top 1%," or "top 10%," "bottom quintile," etc.). Although such aggregation can serve as a simplifying analytic device, it also often obscures the individualistic source of innovation and wealth creation. By addressing distribution out of context and presenting collectivized categories of distribution, Piketty feels justified in claiming that unequal wealth isn't truly earned and thus

can be justly redistributed. Were he to include the context of production he simply couldn't assert such a thing.

The Goal: Economic Capital Punishment

Piketty's ultimate goal is to argue for stricter capital punishment—that is, for even higher tax rates than already exist on capital, capitalists, "rentiers" (bondholders), top executives, and those who've saved wealth over a lifetime and wish to pass their estates to heirs. He claims that capitalism causes excessive capital accumulation, a concentration of wealth in the hands of "nonworkers" receiving "unearned income," and displaces democracy (rule by the majority) with plutocracy (rule by the wealthy). The more capitalism succeeds in accumulating capital and wealth, he contends, the more it extinguishes entrepreneurship and the merit-based society. Absent more punitive taxation of the rich, they'll become richer still and the poor poorer (albeit relatively), while the middle class will stagnate, inequality will "worsen" (being presumed "bad" in the first place), government will become more corrupted (by "plutocrats"), and dispirited "masses" will seek redress by social unrest.

In his own words:

> The overall conclusion of this study is that a market economy based on private property, if left to itself, contains powerful forces of convergence [decreasing inequality], associated in particular with the diffusion of knowledge and skills; but it also contains powerful forces of divergence [increasing inequality], which are potentially threatening to democratic societies and to the values of social justice on which they are based. The principle destabilizing force has to do with the fact that the private rate of return on capital, r, can be significantly higher for long periods of time than the rate of growth of income and output, g. The inequality $r > g$ implies that wealth accumulated in the past grows more rapidly than output and wages. This inequality expresses a fundamental logical contradiction. The entrepreneur inevitably tends to become a rentier [bondholder], more and more dominant over those who own nothing but their labor. Once constituted, capital reproduces itself faster than output increases. The past devours the future. The consequences for the long-term dynamics of the wealth distribution are potentially terrifying, especially when one adds that the return on capital varies directly with the size of the initial stake and that the divergence in the wealth distribution is occurring on a global scale. The problem is enormous, and there is no simple solution. Growth can of course be encouraged . . . [but] the right solution is a progressive annual tax on capital. This will make it possible to avoid an endless inegalitarian spiral. . . . [I]f we are to regain control of capitalism, we must bet everything on democracy [and] develop new forms of governance and shared ownership intermediate between public and private ownership. (pp. 571–73)

And:

> When the rate of return on capital (r) significantly exceeds the growth rate of the economy, as it did through much of history and until [the end of] the 19th century, and is likely to be the case again in the 21st century, then it logically follows that inherited wealth grows faster than output and income. . . . Under such conditions, it is almost inevitable that inherited wealth will dominate wealth amassed from a lifetime of labor by a wide margin, and the concentration of capital will attain extremely high levels—levels potentially incompatible with the meritocratic values and principles of social justice fundamental to modern democratic societies. (p. 26)

A social democrat, adviser to the French Socialist Party, and professor at the Paris School of Economics, Piketty concedes that his interpretation is "apocalyptic" (p. 27), yet also warranted, for he finds "potentially terrifying" the prospect of a capitalistic 21st century accumulating too much capital and concentrating too much wealth in the hands of an "undeserving" minority, a world in which inheritance trumps democracy and "the past devours the future." Piketty is not, strictly speaking, a Marxist: he doesn't believe in the labor theory of value (the notion that manual labor alone creates economic value), doesn't contend that excessive capital accumulation will depress the rate of profit (return on capital) toward zero, doesn't endorse public ownership of the means of production, and eschews violent revolution. Yet he agrees with Marx that capitalism is inherently unstable; that capitalists' incomes are "unearned" and ought to be expropriated (but by confiscatory tax rates instead of armed revolution). Also, unlike Marx, who advocated outright communism, Piketty wants a political-economic system that he describes as "shared ownership intermediate between public and private ownership" (p. 573). He'd allow businessmen to retain at least nominal ownership of the means of production, and hopes they'll continue creating wealth even as the state would regulate their businesses, tax their profits, and redistribute their wealth in a system more akin to fascism than communism.

It is revealing (of his ideology) that Piketty so loathes the so-called Gilded Age (1865–1913), those five remarkable decades when production skyrocketed and living standards soared, as industrialists and financiers, free of heavy taxes and heavy regulations, and using sound, gold-based money, founded new firms, built new industries, and erected opulent mansions (348–50). Capital accumulated and inequality grew in that age, but so did incomes broadly. In contrast, Piketty loves the three decades of 1914–1945, when inequality plummeted, as capital was destroyed by two world wars, the Great Depression, and the more onerous tax rates, inflation, and regulations associated with the New Deal welfare state. This was all

a "positive thing," he writes, "in that it reflected in part a deliberate policy choice aimed at reducing—more or less consciously and more or less efficaciously—the market value of assets and the economic power of their owners" (149).

Piketty fears a return to a new Gilded Age, in the 21st century, in which he envisions lazy inheritors feeding off huge bond portfolios, where "the past devours the future." To avert this apocalypse, he advises governments around the globe to devour capital, by imposing annual tax rates of up to 80% on high incomes (pp. 473, 512)—roughly double current tax rates—and up to 10% (also annually) on the net worth of the very wealthy (p. 530). The aim of such high tax rates, Piketty says, isn't to raise funds for state functions, but to radically impede saving, investment, and capital accumulation (the same accumulation that historically has boosted labor productivity and living standards). "The primary goal," he concedes, "is obviously not to raise additional revenue (because these very high [tax] brackets never yield much)"; "it is rather to put an end to such incomes and large estates, which lawmakers have . . . come to regard as unacceptable and economically unproductive" (p. 505). Welfare state governments today extract roughly 40% to 50% of national income from taxes—ten times the share taken a century ago—but Piketty recommends that this take be increased to as high as 75%. He also suggests that governments "establish a ceiling on the quantity of capital one can envision accumulating" (p. 563).

Piketty also wants to punish public bondholders (rentiers)—those who've purchased part of the national debt—because, he believes, they're mostly rich types and thus should be taxed instead of receiving interest income (chapter 16, "The Question of Public Debt"). He contends that such bondholders are "the enemy of democracy" (p. 422) and somehow are "favored" (subsidized) by governments that make interest payments (an absurd claim, because public bondholders could as easily invest in alternatives such as corporate bonds or equities). Piketty advocates an implicit *default* on national debt via government action to cause unexpected and higher inflation, which, he hopes, will surprise (rob) bondholders, who otherwise would anticipate the higher inflation and demand higher interest rates to offset lost purchasing power on bond repayments. He's pleased that major central banks have kept interest rates artificially low in recent years, and wants the policy continued. His hatred of the lender, the interest-taker—a hatred felt also by Marx, Keynes, and other anticapitalist predecessors—is palpable and arguably biblical. In an account of capital taxation in medieval times, he commends anti-usury laws (which forbade interest on loans), as well as people who were "wary of infinite accumulation" and believed "income from capital was supposed to be used in healthy ways, to pay for

good works," and "certainly not to launch into commercial or financial adventures that might lead to estrangement from the true faith" (p. 531).

Class-Based Empirical Data on Economic Inequality

The best aspect of this book is its vast, well-presented empirical data. Piketty provides graphs depicting many decades of national income (defined by economists as the sum of all wages, salaries, profits, interest, dividends, and interest received by individuals in a nation in a given year), plus the share of national income that has gone to "labor" (wages and salaries) and "capital" (profits, interest, dividends, and rents). He also plots shares of national income received by various percentiles or deciles of income recipients and wealth holders (e.g., the top 1%, top 10%, middle 40%, bottom 99%, bottom 90%, etc.). Notably, Piketty rarely acknowledges that income and wealth are, in fact, *created*, *produced*, *earned*, or *justly deserved*. At most, he concedes, *manual labor* earns its way, but the rich and wealthy, he says, "do not work" and grow rich by (allegedly unearned) inheritance, "unearned" executive pay (set by cronies), or sheer luck. Oddly, Piketty notes how "it has been well known [by economists] since the 1950s that accumulation of physical capital explains only a small part of long-term productivity growth; the essential thing is the accumulation of human capital and new knowledge" (p. 586, n35). By implication, however, he questions this well-known fact, as he essentially denies the role of *mental labor* in wealth creation.

Piketty also plots inheritances, inflation, savings rates, investment, the degree of capital intensity (the ratio of capital stock to national income), and historical rates of return on invested capital (capital income as a percent of total capital stock). The general reader may be surprised to learn that the bulk of national income in the world's most advanced economies is received by "labor" (75%)—triple the share received by "capital" (25%). Piketty illustrates how these relative shares have fluctuated a bit over the centuries (pp. 200–201, 222), with no "inevitable" tendency favoring one share or the other. Yet there is no doubt that labor receives most income—and no doubt, too, that Piketty believes capital's share is unjust, because "unearned." In his words, he "rejects the conventional wisdom that modern economic growth is a marvelous instrument for revealing individual talents and aptitudes" (p. 85).

Piketty empathizes with those who "live in humble conditions," owning "nothing but their labor power," for "it is difficult for them to accept that the owners of capital appropriate so much of the wealth produced by their labor" (p. 40). Here he parrots Marx, claiming capitalists "appropriate" their wealth from labor. According to Piketty, not even entrepreneurs are sufficiently active or

creative to earn their high incomes: "[E]ntrepreneurial labor should be treated as one treats other forms of labor," he declares, like mere manual labor (p. 41).

The historical data in *Capital* show that the level of capital intensity (i.e., the ratio of capital stock to national income, aka capital/income ratios) in Britain and France in the 18th and 19th centuries as well as in Germany and the United States from the late 19th century until World War I was seven to one (pp. 116–17, 141, 151). Piketty shows that national income across the globe increased by only 0.5% annually from 1700 to 1820, but that was five times faster than in prior centuries; thanks to industrialization, income growth then accelerated to 1.5% annually from 1820 to 1910 (p. 73). Because he so disdains the greater inequality that accompanied industrialization, Piketty fails to note that the acceleration in income growth from 1820 to 1910 was made possible by greater capital accumulation and capital intensity.

Tragically, capital/income ratios plunged by more than half (to three to one) between 1913 and 1945, due to world wars, alternating inflations and deflations, high tax rates, expanded regulation, and the Great Depression. In Piketty's view, this plunge in capital intensity among the newly industrialized nations reflected "Europe's suicide" and in particular "the euthanasia of Europe's capitalists." Yet he looks *favorably* on that destruction: "[T]he low level of the capital/income ratio after World War II was in some ways a *positive thing*," he writes, for it reflected "a deliberate policy choice aimed at reducing—more or less consciously and more or less efficaciously—the market value of assets and the economic power of their owners" (p. 149, emphasis added). Piketty *applauds* the destruction of 1913–1945 because it abated the trend of rising wealth inequality in the 19th century and coincided with a three-decade decline in inequality in both Europe and the United States (p. 349). Since 1945, capital intensity (the stock of capital relative to national income) has increased in Europe (p. 147), in the United States (p. 151), and elsewhere, but capital/income ratios still haven't reached pre-1913 levels. But because he opposes rising inequality, Piketty opposes capital's revival and wants higher tax rates to preclude a return to Gilded Age rates of capital intensity.

On income inequality measured *before* taxes and transfers (government redistributions), Piketty illustrates how in Anglo-Saxon nations the top 1% in income saw a decline in their income as a portion of national income—from 20% in 1910 to 10% at the end of World War II—before rising steadily to about 15% by 2010 (p. 316); a similar pattern occurred in Europe, but without a postwar rebound (p. 317). Meanwhile, the top 10% in income in Germany, the United States, and Britain saw a decline in their portion of national income from 45% in 1910 to roughly 30% by 1970, before rising to 36–48% by 2010 (p. 323). Clearly, income

inequality is now *less* than it was a century ago—the top 1% now earn 15% of national income, versus 20% in 1910—yet Piketty is disturbed by this, because the more recent trend has been upward, and he predicts this will persist, to repeat Gilded Age inequalities during this new century.

Were Piketty a pure egalitarian, he'd demand that the top 1% get 1% of national income while the top 10% get 10%—and so on. He doesn't go *that* far, but goes pretty far, still—and thus condemns today's income distribution. He shows that in the United States in 2010 the top 10% in income received 70% of total income whereas the middle 40% got 25% and the bottom 50% got 5%. In his "ideal society," he says, the top 10% would get only 30% whereas the middle 40% would get 45% and the bottom 50% would get 25% (p. 248). Likewise regarding wealth, Piketty reports that the top 10% wealth holders in the United States in 2010 held 50% of total wealth, whereas the middle 40% held 30% and the bottom 50% held 20%; in his "ideal society," the top 10% would hold just half as much (25%), whereas the middle class would hold 45% and the bottom 50% would hold 30% (p. 249). Once again, Piketty assiduously avoids such questions as who *earns* what, and how—and provides no objective case for his allegedly ideal income shares.

Focused as he is on relative, not absolute incomes, Piketty fails to report on the huge rise in living standards (life span, health, living conditions, leisure time, etc.) seen during the post-1970 increase in income inequality. From 1970 to 2006, world population increased 80%, from 3.61 billion to 6.49 billion, yet those living on $2 per day or less (in real terms) plunged 48%, from 1.64 billion, to just 85 million; and the proportion of abject poor in the world has plunged from 45% to 13%.[12]

This clear plunge in poverty is of no interest to Piketty; he seems to prefer no advances in living standards if those advances entail greater degrees of inequality. Notably, he agrees with a recent IMF study, that "income inequality has increased in both advanced and developing economies in recent decades" due to

> the globalization and liberalization of factor and product markets; skill-biased technological change; increases in labor force participation by low-skilled workers; declining top marginal income tax rates; increasing bargaining power of high earners; and the growing share of high-income couples and single-parent households. Many of these developments have had beneficial effects on growth and poverty reduction both nationally and globally.[13]

Why would a liberty-respecting, prosperity-promoting economist believe any of these causes or effects to be bad? He wouldn't. But an egalitarian economist would. He also would applaud the *purpose* of the IMF study—"to provide guidance to policymakers on options to achieve their desired level of redistribution in the

most efficient manner"—and its motivation, too—"widening income inequality has been accompanied by growing public demand for income redistribution."[14]

A crucial defect in Piketty's anticapitalist case is selection bias. Recall that he investigates only those nations and eras in which income and wealth are measured more readily and more accurately. These, it turns out, are precisely the more capitalistic-industrialized nations and eras of which Piketty is so critical. But what of the less-developed, poor nations and eras absent from his study? He ignores evidence that richer nations and eras tend to exhibit less inequality than poorer nations and eras.[15] This evidence may not be as easily available and digestible as the data Piketty has gathered and cited, but it is nevertheless evidence, and it is relevant. The egalitarian seeking more-equal societies should favor more capitalistic ones, but Piketty does not. He is less an egalitarian than he is an anticapitalist. His study also omits abundant evidence that economic mobility—movement up and down the income and wealth scales—tends to be greater in more capitalist economies, in which the "top 1%" in any decade are rarely the same people (or the same firms) that are the top 1% in another decade.[16] Logic tells us that there's a far greater chance of our advancing in more vibrant, wealth-generating economies, yet Piketty wants to squelch just such economies, with stultifying tax rates on rising incomes and growing wealth.

Some of Piketty's empirics are also badly biased—and usually in favor of his claim of rising inequality. For example, he classifies income recipients *functionally*, as "capital" and "labor." This is the cartoonish view of capitalism: the cigar-chomping, fat-cat capitalist, lounging in his corner office while appropriating unearned wealth from the grimy, sweaty laborer toiling below on a soulless assembly line, actually creating the wealth—but not being paid for it. In truth, of course, most individuals in industrial economies perform many and distinct functions. Most "laborers" in factories receive "labor income" (wages), yet also have savings and pensions, which yield "capital income" (dividends, interest). Likewise, a corporate CEO will receive "labor income" (a high salary, with bonus), but also capital income, should he own his business. A retiree mainly receives capital income but may also liquidate his capital, or instead preserve it to pass to heirs—and his income is no less earned merely because he is "not working" (as a manual laborer). Piketty dishonestly uses the concepts "capital income" and "labor income" to insinuate that laborers don't also earn capital income, and that capitalists don't also earn labor income.

Piketty's most opaque treatment is of capital itself—the main subject of his book. He includes in "capital" not merely traditional, tangible capital (property, plant, and equipment) but also household and business net worth (defined as assets minus liabilities), financial assets (stocks, bonds, pensions), and even residential

housing (even though it's no part of production). Piketty insists that "housing capital" yields capital income (rent) because homeowners needn't pay rent; the absence of an expense, he claims, is income. Such inconsistent definitions and overlapping measures of capital permit Piketty to selectively double count, so as to more easily exaggerate the extent of the capital stock and imply that capital income is growing faster, relative to labor income, than it really is.

Perhaps the most crucial feature of Piketty's book—and the one likely to have the most lasting and deleterious impact on economists, citizens, and policy makers—is his claim that a few "fundamental laws" of capitalism portend a gloomy future, which can be avoided only if politicians impose even more confiscatory taxes and regulations than they impose already. In effect, Piketty tries to dress his naked assertions about capitalism in mathematical garb (mostly algebra) to make them appear scientific; in fact, upon close examination (see the appendix), both his supposed "laws" and algebraic manipulations are either irrelevant to his theme or patently false.

A (Partially) Valid Defense of Political Economy

To his credit, Piketty is critical of the detached state of academic economics in recent decades. As he (rightly) tells it, "economists are all too often preoccupied with petty mathematical problems of interest only to themselves," with "purely theoretical and highly ideological speculations" and "ways of acquiring the appearance of scientificity without having to answer the far more complex questions posed by the world we live in." "The truth is that economics should never have sought to divorce itself from the other social sciences and can advance only in conjunction with them" (pp. 32–33).

This is an important and valid critique—one that, ironically enough, only further discredits Piketty. What used to be called "political economy" in the 18th and 19th centuries gave way, just before the start of the 20th century, to mere "economics," and, eventually, to an exclusively mathematical economics. Political economy has made a comeback of sorts in academia lately, although mainly in political science departments. Piketty is correct that economics is done better when integrated with the disciplines of ethics, politics, and history, but there's no assurance it will turn out better if, in fact, the theories embraced in each field are false. In Piketty's case, he's right to call for a more interdisciplinary approach to economics, and his book is an instance of that. Nevertheless, he embraces certain ideas—Rawlsian altruism in ethics, envy in psychology, capital destruction and punitive taxation in economics, social democracy and statism in politics—that

are harmful to human well-being. Piketty glimpses truth when he says "political economy sought to study scientifically, or at any rate rationally, systematically and methodically, the ideal role of the state," with "an unabashed aspiration to study good and evil" (p. 574). Yet he believes capitalism is "unjust," hence unethical; this bias makes him look for cases of capitalism's supposed practical failures, due to an alleged "central contradiction." Besides, how can an "evil" social system nevertheless work so well and produce so much? It's either not evil, in fact, but morally good, or it is evil, indeed, and thus must be portrayed as "unsustainable."

Democracy against Capitalism

In Piketty's view, democracy—unlimited majority rule—trumps capitalism, liberty, and rights. "It is not right for individuals to grow wealthy from free trade and economic integration" (p. 522), he declares, and it is "particularly dangerous" "to see the free circulation of people, goods and capital as fundamental rights with priority over the right [of states] to promote the general interest of their people" (pp. 566–67). Thus, Piketty seeks "ways democracy can regain control over capitalism and ensure that the general interest takes precedence over private interests" (p. 1). He warns repeatedly that capitalism ought to be restrained because it squelches both democracy and the meritocratic society; in truth, it is democracy that requires restraint, because it is the system that squelches capitalism—and with it, liberty, merit, justice, and equal protection of the law. Piketty's push for democracy further explains the nearly instant and ubiquitous acceptance of *Capital* among reviewers and essayists; the more academic ones like the book because it confirms their irrational hatred of capitalism, whereas the more popular ones like it because it confirms their irrational love of mob rule.

The central contradiction in Piketty's system is this: He denies one has legitimate rights to things one produces, earns, and receives by inheritances. But he claims one has basic, minimal "rights" to such things as education, income, health care, and housing—a claim that necessitates compelling others to produce, deliver or pay for such goods—a claim that some have a "right" to violate others' rights.

As a social democrat, Piketty wants not violent revolution but majorities who vote for politicians and regimes that punitively regulate and tax the owners of capital, whether physical-tangible capital (the property, plant, and equipment of firms) or financial capital (bank accounts, stocks, bonds, mutual funds, and pensions). He doesn't believe the targeted minority (capitalist) has inviolable rights or constitutional protections for his property; he believes people have a right only to create wealth initially, but no right to fully control it, trade it, or pass it to heirs.

Is Piketty worried about cronyism or plutocracy? They're caused by the welfare state he so favors, with its redistribution (by taxes, subsidies, regulations); that's why the rich today pay to influence elections, officials, and policies. So long as the welfare state exists, the rich will pay for favors, while politicians accept payments and dole out favors. To get money out of policy making, we must get politics out of money making. Instead, Piketty recommends an even *more* politicized economy than we have already.

Piketty gives much history, but where does he (and his book) stand historically? Political economy can be bifurcated into those theorists sympathetic to Enlightenment ideas (egoism [implicitly], individualism, rights, the rule of law, capitalism) and those theorists who've embraced contrary notions (altruism, collectivism, duties, legal caprice, statism). The former include those who focused on ways to *enhance* human living standards, the *production* of wealth, and general prosperity, while also alleviating poverty (Adam Smith, Jean-Baptiste Say, Frederic Bastiat, Ludwig von Mises, and James Buchanan). The latter include those who, while presuming some inherent conflict among classes of men, sought to *restrain* liberty, who focused on relative economic status and the *distribution* (and *redistribution*) of wealth, even though that might sustain or spread poverty (David Ricardo, Karl Marx, John Stuart Mill, John Maynard Keynes, and Paul Krugman). Undoubtedly, Piketty is in the latter camp—as he often and openly admits.

To reiterate: The distribution of income and wealth is a legitimate and crucial field in political economy. No process of production and exchange can be fully understood without a comprehension of distribution—that is, without understanding who earns income and wealth, how much they earn, and how they earn it. Not all individuals and firms contribute equally to production; consequently, none equally earn income or wealth. Distribution theory is necessary, yet it necessarily goes awry whenever economists sever distribution from its prerequisite, production—or whenever economists presume that mental labor is "unproductive" or that income from investments or inheritance is "unearned." In a free economy of voluntary exchange, the reasonable presumption must be that incomes, wealth, and inheritances are earned. When millions of economic exchanges of value for value are voluntary and just, no one can claim with any legitimacy that the resulting pattern of distribution is, in aggregate, "socially unjust." Nor can one claim that the "least advantaged" deserve the wealth of others merely *because* they're the least advantaged. Unless someone has initiated physical force or fraud against them, the status of the "least advantaged," however

unfortunate some of them may be, is not the fault of others and does not justify legalized larceny.

We live in an age when everyone heralds diversity, difference, and variety—especially if exhibited by minorities. There's a crucial, contradictory exception: the *diversity of income and wealth* exhibited by the differently born, differently raised, differently intelligent, differently schooled, differently ambitious, differently skilled, differently innovative, and differently productive. The top minority—the elite—the "1%"—face perpetual intolerance, hatred, prejudice, and legalized robbery. The culprits are the pushers of altruism, populism, egalitarianism, and socialism. Those who doubt whether all incomes are justly earned, because not freely attained, should advocate for more freedom, not less. The free, capitalist system encourages and protects human diversity, as revealed most obviously in its division of labor and labor specialization—principles indispensable to the creation of material abundance and social harmony. There can be no capitalism without capitalists and vast capital accumulations.

Ultimately, debates about economic inequality—no matter how *empirically* well informed—are senseless without reference to what is *earned* (or not).[17] So long as men interact voluntarily and exhibit diversity in talents, we should *expect* to see ubiquitous but differential earning power and with it vast economic inequality—and we should *celebrate* that, not fear it, hate it, or tax it. Piketty wants no such debate, or sees it as unnecessary, because he simply *presumes* inequality to be a bad thing, never a *good* thing that reflects the plain fact that all men are *not* created equal in various respects. Worse, he opposes the only legitimate and defensible form of human equality: the *political* form—equal protection of the laws—because he wants laws, tax codes, and courts that discriminate against (and punish) the wealthy. Although this vile and vicious policy agenda distorts Piketty's political economy and makes it prone to error, there's more than enough valuable factual history and decent analysis in *Capital* to make it well worth the study.

Appendix: The Fuzzy Math in Piketty's "Laws" of Capitalism

A crucial feature of Piketty's book, which is likely to have a lasting and deleterious impact, is his use of the data to develop what he insists are the few "fundamental laws" of capitalism—laws that he deploys to project capitalism's gloomy future. In truth, each of his "laws" is either irrelevant or false.

What Piketty calls the "first fundamental law of capitalism" (pp. 52–55) is but an algebraic expression that the *share of capital income* in national income (i.e., capital income/national income, designated by *a*) is equivalent to the *rate of return on*

capital (i.e., capital income/capital stock, designated by *r*) multiplied by the *degree of capital intensity* (i.e., capital stock/national income, designated by *ß*). This isn't a law, per se, but a mere accounting identity, true necessarily by construction. A valid economic law must entail explanation (causality), not mere description.

What then is the use of Piketty's first law? We know he's obsessed with the *share of capital income* (*a*), that he fears it's too high and will keep rising this century. With his first equation, Piketty tries to imply that capital's income share is "caused" by the joint interaction of the return on capital and the degree of capital intensity. But this is insupportable, for it involves no theory of these component factors, thus no basis for claiming they'll cause an economically "unsustainable" (let alone a morally "unjust") income share for capital. If, instead, Piketty were to demonstrate that capital's return is caused by entrepreneurial talent—or to prove that capital intensity reflects a capitalist's rational choice (based on expected returns) to save, invest, and accumulate capital faster than others generate income—he'd have to admit that capital income is *earned*, and that the more of it there is in an economy, the stronger the economy will be.

Piketty's "second fundamental law of capitalism" (pp. 55, 166–70) states that, in the long run, the *degree of capital intensity* (*ß*) will equal the ratio of the net savings rate (saved income as a portion of national income, less depreciation, designated by *s*) to the annual growth rate of national income (designated by *g*). Net savings are assumed to be fully invested and thus equivalent to an addition to the existing capital stock. In short, $ß = s/g$. If $s = 10\%$ and $g = 2\%$, then $ß = s/g = 5$. A simple algebraic transformation reduces this identity to a rather trite proposition (not truly a "law"), namely: there's a close correspondence between the growth rates of a nation's income and capital stock. Economists first hypothesized this relationship in the 1950s but saw no dire consequences involved. Not so Piketty. He portrays this "law" as entailing the danger of perpetually greater capital income. It means, he declares, that "a country that saves a lot [of capital] and grows [its national income] slowly will over the long run accumulate an enormous stock of capital (relative to its income), which can in turn have a significant [negative] effect on the social structure and distribution of wealth" (p. 166). In Piketty's view, more saving is problematic, because it adds to the capital stock, which increases capital intensity; and, according to his first "law," capital's share of total income (*a*) is the product of *capital intensity* (*ß*) and the *return on capital* (*r*), in short: $a = ß$ times *r*. Thus if $ß = 5$ and $r = 5\%$, capital's share of income (a) = 25%.

At this point Piketty performs another sleight of hand, by assuming firms can easily and affordably use capital in place of labor in any production process. In

technical terms, he posits a ridiculously high "elasticity of substitution" of capital for labor (pp. 216–24). In essence, he says, robots will take over—and devour us. This is Piketty writing science fiction, albeit more of the latter than the former. His assumption contradicts all prior findings by economists, and it verges on a denial of *the law of diminishing marginal productivity*, which states that the more a factor (capital, labor) is used in production, all else constant, the less it will add to total production. Piketty makes the assumption of miraculous factor substitution (managers can easily and limitlessly substitute capital for labor) because, through some fuzzy math, he can more easily project an "inevitable" displacement of labor by capital—and thus push his theme of a growing "dominance" of the latter. Likewise, he questions *the law of diminishing returns* (on factors of production), which says that the more a factor is used, the less it will return (or earn). In effect, Piketty implies that capital can accumulate without limit relative to the other factors of production (intelligence, labor, raw materials). It can't. He concedes that a large accumulation of capital would necessarily (and all else equal) reduce the *return on capital* (capital income/capital stock, or *r*); yet he maintains that the *degree of capital intensity* (capital stock/national income, or *ß*) can simultaneously rise to more than offset the decline in capital's return, such that capital's share of national income rises. If initially *ß* = 5 and *r* = 5%, capital's share of income (*a*) is 25%, but capital's income share can rise even if *r* declines to, say, 4%, so long as *ß* rises to at least 6.5 (such that *a* = 26%). Piketty makes it easy, at least in his mind, for capital's income share to increase indefinitely, even though it hasn't done so historically. If capital's share of income can rise without limit, perpetually, so can its share of w*ealth*, as saving and investment add to the capital stock. Beware then, he warns, of a new, dastardly Gilded Age.

Of course, in addition to questioning these two actual economic laws—the law of diminishing marginal productivity and the law of diminishing returns—Piketty also rejects the valid principle that *connects* the two: people in a free economy, regardless of income level, (generally) are *paid for what they add to net production*, no more, no less. Piketty, instead, says the well paid are overpaid and unjustly paid.

Occasionally, Piketty seems to sense that he's being arbitrary in his stories about capital accumulation. Late in the book, he notes, "I have not yet asked what *ß* [level of capital intensity, or capital stock/national income] is desirable. In an ideal society, should the capital stock be equal to five years of national income, or ten years, or twenty? How should we think about this question? It is impossible to give a precise answer" (p. 563). Yet the real question should be: desirable . . . *to whom*? Is it desirable to the savers and innovators who create and invest in capital, or to central planners and the egalitarians who advise them? Moreover, what is

the "ideal society," according to Piketty? He tells us explicitly: It's the society that cares more about "social justice" than about actual justice; that derides certain earned incomes as "unearned"; that only "permits" inequality if it can be shown to help the poorest and "least advantaged" (who somehow "deserve" others' wealth); the society in which democratic mob majorities trump and trample individual rights; in which income inequality is roughly *half* of what it is currently (pp. 248–49). By these criteria, Piketty wants far *less* capital intensity—thus a more labor-intensive economy—thus a less-productive, less-prosperous economy—which means: a primitive, preindustrial, noncapitalistic economy. His "ideal" is surely no prosperous Gilded Age.

Piketty's third (and final) "law" is the most important. It has received the most academic and media attention and acclaim—mainly because he dubs it "the central contradiction of capitalism." It is also the most wrongheaded of Piketty's propositions. Here he draws on economic literature from the 1960s on "dynamic efficiency," a literature that tried to assess the true relationship between capital accumulation and national income—in essence: the cause and consequences of various degrees of capital intensity (capital stock/national income, or β).

In 1961, professor Edmond Phelps posited a "golden rule of capital accumulation," which he defined as $r = g$, where r = the rate of return on capital and g = the annual growth rate of national income. This "golden rule" implied that over the long run capital's share of national income (a) would equal the savings rate (s)—which effectively meant that capital intensity would be relatively stable. Phelps (and others) made the commonsense point that a free economy would not "over-accumulate" capital, because were it to do so, the return on capital would decline, thereby make it more profitable to use relatively more labor (versus capital) in production. Phelps neglected to note that the historical norm was r > g, not r = g. But at least he grasped the principle that a reasonable, balanced relationship would exist between the capital stock and the income it helped generate—and not just capital income but labor income too, because capital makes labor more productive and better paid. Piketty resists this common sense. He imagines contradictions, imbalances, the "terrifying," "apocalyptic," and social unrest. Yet we can *avoid* all this, he insists, if we just vote for 80% tax rates and fascist-like regimes.

In *Capital*, Piketty deliberately misuses "the golden rule of capital accumulation" when he implies that a sustained *departure* from the equality, $r = g$, can lead to an ever-increasing share of capital income in total income; hence an intensifying "domination of labor by capital," and return to the allegedly hereditary, dynastic, "patrimonial capitalism" (Piketty's phrase) of the Gilded Age. The departure he most detests and

fears is a rate of return on capital that's perpetually *greater* than the growth rate of national income, or $r > g$. At times Piketty declares that $r > g$ will lead to an *increase* in inequality, but at other times he says the differential relates only to *existing* degrees of inequality (only the latter point is true). Regardless, he finds that for centuries, on a pretax basis, the rate of return on capital (r) has *always* exceeded the growth of income (g); that is, $r > g$ has been the *norm* (p. 354). He further shows that only on an *after-tax* basis—and only during the most destructive decades of the 20th century (p. 356)—has the return on capital sometimes been *below* the growth rate of income (i.e., $r < g$). He concedes that "it is an incontrovertible historical reality" that the return on capital has been "systematically higher than the rate of growth"—at least *prior to the taxation of capital returns*. And "indeed, this fact is to a large extent the very foundation of society itself: it is what allowed a class of owners to devote themselves to something other than their own subsistence" (p. 353). Yet, he adds, "I take this to be a historical fact, not a logical necessity." What "logical" alternative, historically, has inverted the long run excess of capital's return versus income growth? High taxation and other means (e.g., war) of destroying capital and *limiting its accumulation* (as occurred during 1913–1945). Piketty, we know, *likes* such destruction, and advises confiscatory tax rates, to erode capital—which he admits is "the *very foundation* of society itself." Here Piketty seems oddly sympathetic to nihilism.

Perhaps the most egregious error in *Capital* is Piketty's claim that a capital return higher than the growth rate of national income ($r > g$) is a "central contradiction of capitalism" and must necessarily cause a rising rate of inequality. In fact, $r > g$ isn't a "contradiction" at all, and elsewhere even Piketty calls it "an incontrovertible historical reality" (p. 353). How can *reality* be contradictory? Piketty also reveals that for much of modern (i.e., industrialized, capitalistic) history, inequality has been *declining*; but how can that be, if, as he claims, $r > g$ invariably generates *increasing* inequality? Answer: because it *doesn't* so breed—indeed, *can't*. Piketty alone, not reality, is the party guilty of being contradictory.

A genuine contradiction would arise if someone were to claim that capital's rate of return *cannot* or *should not* exceed the growth rate of national income. By algebraic transformation, $r > g$ means nothing but that capital income is higher than net savings (defined as gross savings minus depreciation of capital), which merely means part of capital income is consumed, not saved. Economists have known this banality for decades; it's noncontroversial market behavior and has *nothing* to do with rising inequality. Suppose, initially, the capital stock is \$500, national income is \$100, capital's share of income (a) is 24%, labor's share (100% – a) is 76%, r = 5%, and g = 3%, such that $r - g$ = 2 percentage points. By definition, capital intensity

(capital stock/national income, or β) = 5 ($500/$100). A year later, we have a 3% rise in national income (g = 3%), to $103, capital income is $25 ($r$ is 5% times capital stock of $500), and labor income is $78 ($103 – $25), such that capital's share of income (a) is 24% ($25/$103), while labor's share (100% – a) is 76%. The capital/labor shares are *unchanged* one year to the next; there is *no increase in inequali*ty, and no higher relative share for capital merely because $r > g$.[18] Moreover, this result holds only if capital intensity (capital stock/national income, or β) is *unchanged* year over year—which means the capital stock must *increase* as much as national income does (in this case, by 3%). If there's no (or insufficient) capital accumulation, capital intensity will decline, and with it, capital's share of income.

In short, $r - g$ relates to an *existing* and *stable* degree of income "inequality"; only if the $r - g$ differential *changes* will income shares (and inequality) change, but then only once, after which income shares will remain stable. A *wider* differential between r and g means that capital's share of income will increase relative to labor's share, whereas a *narrower* differential between r and g means capital's share will decrease relative to labor's share. A *perpetual* rise in capital's share of income, as Piketty claims to fear, would require a *perpetual widening* of the $r - g$ differential, which hasn't happened historically and indeed *cannot* happen, logically, given the (noncontradictory) and immutable laws of economics.

If, as is clear from the above example, a stable differential for $r - g$ does *not* imply an inevitable, perpetual rise in inequality, why would an intelligent scholar such as Piketty suggest that it does, and why would so many trained economists so readily believe it? Even if Piketty genuinely believed it is true, why wouldn't he seek ways to narrow the $r - g$ differential by advocating policies that would raise g (the growth rate of national income)? Why not advise *lower* tax rates—to better respect the property rights of capital owners and wealth producers—while fostering growth and prosperity? That is not Piketty's aim. He's an egalitarian, so his focus is on relative, not absolute income, and his goal is to substantially close this wealth gap even if that requires violating rights and deterring wealth-creation. His aim is to punitively tax capital. Leave aside the question of whether his motives entail plain envy or just a broader, anticapitalist hatred. It appears he's imagining and stressing the supposed dangers of $r > g$ in order to justify his punitive tax agenda; he hopes this will reduce r and thus narrow the $r - g$ "gap"—ignoring, of course, the likelihood that his punitive tax rates would reduce g.

Endnotes

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11. For an accurate account of the relationships between production, distribution, and consumption of wealth, see Jean-Baptiste Say, *A Treatise on Political Economy* [6th ed., 1821), available at http://www.econlib.org/library/Say/sayT.html.
12. Maxim Pinkovskiy and Xavier Sala-i-Martin, "Parametric Estimations of the World Distribution of Income," National Bureau of Economic Research, October 2009, p. 65, http://www.nber.org/papers/w15433.
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14. "Fiscal Policy and Income Inequality," p. 4.
15. The most common measure of inequality of income or wealth used by economists is the Gini coefficient, which can be between zero (perfect equality) and one (maximal inequality). Gini numbers are generally much larger for poor nations and poor eras. See "World Development Indicators: Distribution of Income or Consumption (2014)," http://wdi.worldbank.org/table/2.9. See also Alberto Chilosi, "Poverty, Population, Inequality, and Development: The Historical Perspective," *The European Journal of Comparative Economics*, vol. 7, no. 2, pp. 469–501. Piketty's book omits GINI data, perhaps because they don't support his thesis.

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