



“Falling out of love with Piketty’s theory”<sup>1</sup>

Piketty’s ‘Capital in the 21<sup>st</sup> Century’ has been experiencing a running in the United States of America (USA), but less so in Europe.

The book, written by French Socialist Party advisor Piketty has been welcomed and utilised by the US Democrats as a means of finding an argument and a way of ‘getting hold’ of the millions of wealthy Americans. Various eminent scholars have offered arguments in support of Piketty’s theory, as well as against it. The theory concerns itself with the study of the concentration and increase of capital in the hands of the happy few at the top of the economic hierarchy. The capital – that is, the value of enterprises, real estate and bonds – are in effect growing faster than the real-world economy<sup>2</sup>. Piketty contends that as a result of this, inequality will continue to grow if changes are not made.

In order to combat tax evasion, he proposes that governments across the globe impose a common tax on capital.

In order to illustrate the impact of this book upon the reader, I shall outline the reviews presented by a selection of scholars, before adding my own comment.

The comment of Guy Sorman<sup>3</sup> is as follows: “So why is Piketty, who is best known in France as adviser for the Socialist Party, hailed as the Messiah in the United States (where he once taught, at MIT)?

Piketty’s title is obviously borrowed from Karl Marx, just as is the thesis he defends, but in a modernized fashion. Piketty shows, with startling statistics dating back over two centuries, as well as historical and literary anecdotes, that owners of capital always manage – except in the case of war – to get richer faster than workers and entrepreneurs. The accumulation of capital in the hands of a minority creates an aristocracy of rentiers, people who live off investment income: they are no longer entrepreneurs, that is, they do not create anything any more”<sup>4</sup>.

<sup>1</sup> First published as a presidential address for the Newsletter May, 2014

<sup>2</sup> Uwe Jean Heuser “Die Wahrheit über Arm und Reich. Die Welt muss umverteilen, fordert der Starökonom Thomas Piketty. Doch wie sauber ist seine Theorie?” in “Die Zeit” dd May 28, 2014, p. 19 and 20

<sup>3</sup> Guy Sorman “The Irony of the American Left’s Love Affair with Thomas Piketty”. This comment dates from May 6, 2014. Sorman is a French philosopher, economist, and public intellectual and author.

<sup>4</sup> Guy Sorman, idem

“This conflict between passive investment and enterprise leads, according to Piketty, to the depletion of capitalism. Marx imagined that such a conflict would inevitably bring the death of capitalism and its replacement by socialism. Piketty does not share this outlook: *the capitalist machine*, incomparable to any other when it comes to wealth creation, *can*, he writes, *be saved by redistributing income*. The “social state,” to use Picketty’s vocabulary, would reconcile business and market efficiency with “social justice<sup>5</sup>.” But this redistribution has broken down these days because income taxation has reached its limits. Therefore, Piketty suggests, capital should be heavily taxed to finance the welfare state. Since capital has no borders, the tax must be global. In Europe the reception of Piketty’s ideas has been only lukewarm because taxation of capital in Germany, Spain, and France has led to capital flight. The priority in Europe now, including for the Left, is not the development of the welfare state but its limitation. In the United States, however, where tax contributions remain relatively low, (although the taxes were sometimes very high in the 20th century), the Democrats are seeking a political model that would distinguish them from the Republicans, one that would reconcile income equality and capitalism. Piketty’s book allows them to remain capitalist while raising taxes. Hence the success of Piketty, who also has the “virtue” of being French. Piketty also fits well with the Occupy Wall Street movement that launched the slogan “We are the 99 percent” (who are supposedly exploited by the 1 percent)”<sup>6</sup>.

Yet, according to Sorman, ‘there is a great weakness’ in Piketty’s theory that has been pointed out by ‘several American classical-liberal economists: at no time does he examine the causes of growth and the perhaps key role of the 1 per cent, who in the United States are nearly all entrepreneurs and not rentiers’.

Sorman continues:

“To explain why the preordained transformation of entrepreneurs into unproductive rentiers hasn’t yet happened, Piketty adds a new twist to Marx. Wars and global crises – “shocks,” in Piketty’s parlance – wipe out accumulated wealth, allowing true entrepreneurship to start anew. This disruption of the status quo may have some historical basis. (Piketty argues convincingly for it in the case of the two world wars) But a more straightforward and less ideological analysis would show that, apart from such cataclysmic events, innovation – or “creative destruction,” as Joseph Schumpeter described it – opens the field to new entrepreneurs, while displacing rentiers. Shocks of the kind Piketty describes are hardly needed”. Sorman comments: “Piketty’s statistics are superficially impressive, but they can’t be taken at face value. His gross income figures, for instance, exclude redistribution and social programs. The inequality figures he cites would be much less striking if he computed them – as is

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<sup>5</sup>The Italics are added

<sup>6</sup> Guy Sorman, *idem*

commonly done – according to net income after redistribution. Not doing so seriously distorts economic conditions.

Moreover, Piketty seems unwilling to concede that income alone, however calculated, does not account for the total social reality: we all benefit from progress in multiple areas – health, transportation, consumer technologies – regardless of income. As advances in productivity lower prices, *real* incomes rise. Piketty’s book has other flaws. The author never considers whether some degree of inequality is necessary for growth in a market economy. (After all, people are different and some are better than others at serving consumers.) Instead, he attacks economists for “relying too much on mathematical models and not understanding the deep structures of capital and inequality.” He thus ignores the fact that the economists he dislikes have identified the actual factors of growth – such as property rights and the rule of law – based on empirical observation. Without the free-market economic models he scorns, countries like China, India, and Ghana would not have seen such spectacular growth – and their poorest citizens would have far fewer opportunities. His explanation of the popularity of the French Revolution and of Napoleon among the French people is remarkable: it was, he demonstrates, a period of high relative wages and low rents as a result of the redistribution of Church property and the mobilization of workers in the service of war. (Whether this is a good way to create prosperity is another story.)”<sup>7</sup>

Sorman concludes: “Nevertheless, Piketty’s American success owes nothing to his talents as an historian. The American Left is looking for a new lease on life, and it hopes to have found it in France. French socialists will appreciate the irony.”

Paul Krugman, of course, agrees with Piketty. He regards ‘Capital in the 21<sup>st</sup> Century’ as ‘the decisive book of the past decade’, declaring in the *New York Times* ‘Piketty, arguably the world’s leading expert on income and wealth inequality, does more than document the growing concentration of income in the hands of a small economic elite. He also makes a powerful case that we’re on the way back to ‘patrimonial capitalism,’ in which the commanding heights of the economy are dominated not just by wealth, but also by inherited wealth, in which birth matters more than effort and talent.’”<sup>8</sup>

Jeff Madrik’s comment is the following<sup>9</sup>:

“Economic data gathered since the early 2000s have shown conclusively that American social mobility is low and has been so for half a century – indeed, it is considerably lower than the nation’s supposedly stultified European competitors, where social safety nets are much larger and taxes

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<sup>7</sup> Guy Sorman: *idem*

<sup>8</sup> Paul Krugman - “Wealth Over Work”, *New York Times*, March 23d, 2014

<sup>9</sup> Jeff Madrik, Comment on book of Piketty “Inequality is Not the Problem” April 24, 2014

much higher. Among the most impressive of the new work is a comprehensive study, led by Raj Chetty of Harvard and Emmanuel Saez of Berkeley, among others, published this January. It shows that income mobility has remained at roughly the same low levels. The main lesson is that a combination of social policies and growth policies are needed that aim at producing rising wages for all. They could include a higher minimum wage, child allowances, and educational programs for the young about the disadvantages of early pregnancies. But they should also include serious stimulus measures by the federal government, including a recognition that deficits are now low enough and that further austerity is unnecessary. In particular, government spending programs should aim to sustain decent income levels through unemployment insurance, expanded earned income and child tax credits, and outright cash allowances. The government should also aim at foundational projects that facilitate long-term economic growth, including intelligent and aggressive expansion of transportation, and Internet infrastructure”<sup>10</sup>.

There is simply no escaping the central fact that the welfare of Americans depends on faster economic growth. Progressives and conservatives should agree on this. This economic recovery so far has been slow. Debt overhangs from the mortgage crisis explain part of it, but the lack of appropriate policy to offset the ramifications of the financial and housing crashes are inexcusable. Efforts to enhance income mobility alone cannot be the answer”<sup>11</sup>.

Madrik’s suggestions indicate that governments involved, whether central or local, would require significant financial reserves in order to achieve the aforementioned goals. Indeed, this is most likely the reason, why Piketty placed such great emphasis on taxing capital so heavily.

One can distinguish two central elements of Piketty’s theory, namely inequality - and how to eliminate it - and social justice. Or better: eliminate inequality by social justice. The “social state,” to use Picketty’s vocabulary, would reconcile business and market efficiency with “social justice.” But this redistribution has broken down these days because income taxation has reached its limits. Therefore, Piketty suggests, capital should be heavily taxed to finance the welfare state. Since capital has no borders, the tax must be global.<sup>12</sup>

Interestingly enough Piketty has published an earlier work on income inequality before publishing this book on “Capital” and there he describes how the percentage that owned 20% of the capital in fact decreased during the period between 1952 and 1982. “In 1928 the top 1 per cent of the population had received nearly 20 per cent of income. From 1952 until

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<sup>10</sup> Jeff Madrik, Comment on book of Piketty “Inequality is Not the Problem” April 24, 2014

<sup>11</sup> Idem

<sup>12</sup> Guy Sorman “The Irony of the American Left’s Love Affair with Thomas Piketty” dd May 6, 2014.

1982 it was consistently less than 9 per cent, below the equivalent share going to the top 1 per cent in France”<sup>13</sup>

Piketty describes how the French public believed in the virtue of meritocracy when they were under the leadership of Napoleon Bonaparte. “His explanation of the popularity of the French Revolution and of Napoleon among the French people is remarkable:” it was”, he demonstrates, “a period of high relative wages and low rents as a result of the redistribution of Church property and the mobilization of workers in the service of war”<sup>14</sup>

Therefore, it appears that the argument being made contends that thanks to the redistribution of properties (clerical and other), the overall wealth of the French public grew. This raises some questions:

- How long did this period of welfare last?
- What was the outcome and influence of the taxes imposed on the Dutch, Italians and Prussians by the French, that were so high, that “the Dutch gave 229 million guilders to the French, more than a year’s national income... and in Italy between 1805 and 1812 fully half of the taxes raised, went to the French treasury”<sup>15</sup>

On top of this “income”, Niall Ferguson argued, “despite continued sales of former Church lands, the introduction of a new currency and the squeezing of the Dutch and Italian taxpayers, Napoleon could not get the cost of borrowing down below 6 per cent”<sup>16</sup>.

This would indicate that redistribution was not the right answer.

The improving economic conditions in France were more a result of the restructuring experienced in the aftermath of the French Revolution. Before the revolution, neither the aristocracy nor the clergy had to work or pay taxes; the middle class was the sector of society tasked with earning money. After the revolution, however, the middle class became endowed not only with duties but also with *rights* – including property rights – thus enabling them to secure their financial wellbeing to a far greater extent than previously.

### **Social Justice and inequality.**

Social justice and with it the topic of inequality are back on stage again and with it the redistribution of income<sup>17</sup>. “Social justice” as used today is not “social” in the sense of “social norms”, i.e. something which has developed as a practice of individual action in the course of social

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<sup>13</sup>Niall Ferguson “The West and the Rest” 2011 p. 238 referring to Piketty Thomas and Saez Emmanuel “Income inequality in the United States, 1913-1998,” NBER Working Paper, no. 8467 (2001) After that period however the inequality grew in the past 30 years.

<sup>14</sup>Guy Sorman “The Irony of the American Left’s Love Affair with Thomas Piketty” dd May 6, 2014.

<sup>15</sup>Nial Ferguson “The West and the Rest” Penguin Books 2011, p. 159

<sup>16</sup>Nial Ferguson idem, p. 161. Ferguson does not mention the fact, that the Prussians were squeezed as well.

<sup>17</sup>F.A. Hayek “The constitution of Liberty, Routledge and Kegan, London 1960, p. 99-100, 385, 387

evolution, ..., but a conception to be imposed upon society".<sup>18</sup> Hayek has already written his arguments against this "weasel word", social.<sup>19</sup>

Hayek contends that "the commitment to "social justice" has in fact become the chief outlet for moral emotion, the distinguishing attribute of the good man, and the recognized sign of the possession of a moral conscience".<sup>20</sup>

"Indeed, it looks not just, when the market forces produce other results than expected when there is social justice. It has of course to be admitted that the manner in which the benefits and burdens are apportioned by the market mechanism would in many instances have to be regarded as very unjust *if* it were the result of a deliberate allocation to particular people. But this is not the case. Those shares are the outcome of a process the effect of which on particular people was neither intended nor foreseen by anyone when the institutions first appeared"<sup>21</sup>

It is certainly true that the market is capricious. Why would someone want to pay for torn jeans, as is the current fashion? Why is Facebook so successful, yet other networking sites struggle? These are questions that require further investigation. That is how the market functions.

Another argument can be made against this call for equality, namely the example provided by the former Soviet Union and the Eastern European countries whose collapse led to the destruction not only of civil society, but also of the welfare of the individual. As concluded by Hayek: 'So long as the belief in "social justice" governs political action, this process must progressively approach nearer and nearer to a totalitarian system'<sup>22</sup>. The former communist governments were so adamant on achieving material equality that they redistributed goods to the point of excess, with the result being that almost everyone was poor.

Consequently, Hayek did not place equality and social justice on a par with freedom. After all "most of the strictly egalitarian demands are based on nothing better than envy"<sup>23</sup>

He made a distinction between justitia distributive (re)distributing justice) and justitia commutativa. (reward according to merit) "Liberalism aims at commutative justice and socialism at distributive justice. But like most socialists, he (Mr. Gallie) does not see that distributive justice is irreconcilable with freedom in the choice of one's activities: it is justice of a hierarchic organization, not of a free society." In the case of a commutative justice a performance will be rewarded by a return and a price will be paid. In the case of distributive justice the favours or rewards are

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<sup>18</sup> F. A. Hayek "Law, Legislation and Liberty", Vol. II, Routledge and Kegan, London 1978 p. 78

<sup>19</sup> F.A. Hayek "The fatal conceit: The errors of Socialism", W.W. Bartley, editor, 1991

<sup>20</sup> F. A. Hayek "Law, Legislation and Liberty", Vol. II, Routledge and Kegan, London 1978 p. 66

<sup>21</sup> Idem, p. 64

<sup>22</sup> F. A. Hayek "Law, Legislation and Liberty", Vol. II, Routledge and Kegan, London 1978 p. 68

<sup>23</sup> F.A. Hayek "The constitution of Liberty", Routledge and Kegan, London, 1960, p. 93

distributed by the government<sup>24</sup>. In the latter case we will be heading to a command economy or dirigisme. Freedom of choice of our profession or of production of the services to be given, cannot be on one line with the principles of social justice. Hayek continues: “ Free choice of occupation and free decision by each of what he wants to produce or what services he wants to render are irreconcilable with distributive justice. It is the justice of a command-society or command-economy and irreconcilable with the freedom of each to decide what he wants to do”. Not only irreconcilable with freedom of action, but also with freedom of opinion”.<sup>25</sup>

As for equality, the presumption exists that people are entitled to material equality instead of formal equality. Liberalism has never promised material equality, only formal equality, which is the equality before the law<sup>26</sup>. “There lies a whole world between the effort to treat people in the same equal way and the attempt to equalize them; The first is the condition for a free society, the second means, like de Tocqueville already indicated “ a new form of bondage”<sup>27</sup>

The arguments against Piketty’s theory may therefore be summarised as follows:

- Piketty’s calculations are based on gross income, instead of net income; when using the latter method, the numbers would be much less impressive;
- His argument that the redistribution of income (facilitated by the expropriation of the Church and aristocracy’s assets) among the French population during the revolutionary period was the primary cause of an overall increase in wealth is not valid. Once the properties have been distributed, there is nothing left and the economy will stop to grow;
- The best way to safeguard global economic welfare is therefore to create growth<sup>28</sup>.
- Piketty’s proposals are short-term in nature, and over a longer period will result in capital flight and the impoverishment of the public; That is not what we are aiming for.
- Piketty has been attacked for the fact that his statistics are not correct. They have been questioned;<sup>29</sup>
- As von Mises argued: “The truth is, that capitalism has not only multiplied population figures but at the same time improved the people's standard of living in an unprecedented way”. He added:

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<sup>24</sup> F.A. Hayek “Law, Legislation and Liberty”, Vol. II, Routledge and Kegan, London 1978 p. 63 with a reference to J.S. Mill.

<sup>25</sup> F.A. Hayek “Studies in Philosophy, Politics and Economics”, Routledge & Kegan , London 1967, p. 258i

<sup>26</sup> F.A.Hayek “Individualismus und wirtschaftliche Ordnung”, Salzburg, 1976, p. 46

<sup>27</sup> Idem, p. 28, with a reference to de Tocqueville “Oevres Completes IX (1886),p.541”une nouvelle forme de servitude”

<sup>28</sup> Jeff Madrik idem

<sup>29</sup> Uwe Jean Heuser in “Die Zeit”, idem p. 19 with a reference to the Financial Times

They (not only socialists, but also Royalists, Catholics,etc) all agree in the fundamental thesis that the very existence of the capitalist system harms the vital interests of the immense majority of workers, artisans and small farmers and they all ask in the name of social justice for the abolition of capitalism”<sup>30</sup>

Time to rethink this proposal before putting it into practice.

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<sup>30</sup>Ludwig von Mises “The human Condition”, Auburn, Alabama, 1998, p. 850 and 671.

See also Angus Deaton “Life is better now than at almost any time in History” in “The Great Escape”, Princeton University 2013, p. 1