Defeating Piketty’s Charge – A working paper

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On the third day of the Battle of Gettysburg, Confederate General Robert E. Lee ordered Pickett's Charge — an ill-advised uphill offensive that spelled the beginning of the end of the Army of Northern Virginia. Defenders of the free society now face Piketty's Charge — an intellectual offensive against the free economy, using the wedge of “inequality” to justify greater government control of economic outcomes.

In broad brushstrokes, this paper explains:
- Why our Freedom Movement must respond to Piketty’s Charge;
- Why we — not the Left — occupy the moral and intellectual high ground on the issue of inequality; and
- How we might exploit glaring weaknesses in our opponents’ arguments.

Let me also provide a “call to action” here. At Atlas Network, we’ve developed a proposal that we're shopping around so that we can support research and advocacy projects to win the Inequality Argument. Contact me at Brad@AtlasNetwork.org if you are doing work in this arena or are interested in collaborating with us in such a project — or, of course, if you would consider funding such a proposal.

The Stakes for Freedom Are High

In March 2014, Thomas Piketty became an international phenomenon as Left-leaning intellectuals embraced his newly-published book, Capital in the Twenty-First Century, as proof that free-market capitalism contains an inherent contradiction that requires more aggressive government intervention to re-distribute wealth.

The book arrived on the heels of the Occupy Wall Street movement, heavily funded by labor unions, which created a meme about the 1% exploiting the 99%. While the Occupy movement faded away, Inequality has remained a “live issue” and Piketty’s book added scholarly heft to it.

I should acknowledge at the outset that Piketty deserves credit for assembling substantial historical data, and for undertaking an ambitious effort to make sense of it. His openness with his data is to be commended, and he has been willing to engage with his critics. All this is to be applauded.

But we should make no mistake: the thesis of Piketty’s book points policy-makers in a dangerous direction. In much of the world, populist economic egalitarianism has not tended toward modest redistribution, but instead toward cronyism and a hallowing out of the rule of law. (See Venezuela.) It is critical that defenders of the free economy understand Piketty’s case, and the arguments against it.
Piketty’s main points are:

- If the rate of return on capital is greater than overall economic growth (and therefore the rate of wage growth), then wealth inequality will grow without end. (This is Piketty’s much-hyped “r > g” maxim, which he presents as the “central contradiction of capitalism.”)
- He claims that his analysis of three centuries of data in the U.S., England, France and Sweden establishes this “r > g” rule.
- He predicts a “potentially terrifying” reckoning that threatens “democratic societies and...the values of social justice on which they are based.”
- He contends that, while it’s relatively easy to measure the value created in low-income jobs (e.g., a fast-food worker), it is more difficult for high-income earners (e.g., a financial services CEO). Since the wages of high-income earners are “largely arbitrary,” they lack moral legitimacy and are fair game for redistribution to avert the forecast crisis of inequality.
- He is also troubled by millions of people who are not part of the “1%” in income, but who live very comfortably on the interest of savings accumulated in the past, or received through inheritance.
- To correct these identified “problems,” Piketty proposes dramatically raising tax rates on incomes above a to-be-determined threshold (he suggests setting an 80% rate for those above either $500,000 or $1 million); and instituting a “global wealth tax” of 10% on large fortunes (with perhaps an even-higher one-time tax at the beginning of the new global tax regime to make a serious dent in wealth inequality).

The book received a hero’s welcome. Paul Krugman declared it “the most important economics book of the year — and maybe of the decade.” Harvard’s Rakesh Khurana asserted, “The book should have a major impact on our discussions of contemporary inequality and its meaning for our democratic institutions and ideals.”

Clearly, this is the where the Left will wage the battle of ideas in coming years.

But if it feels like the Left is “on offense,” we should keep in mind that this is really a retreat following upon historic failures:

- The collapse of the Soviet Union in 1991 won the long argument that for Classical Liberals that centrally planned economies could not compete with entrepreneurial capitalist societies. (An argument that Paul Samuelson did not concede until the bitter end. See the 1989 edition of his textbook, Economics, claim “the Soviet economy is proof that, contrary to what many skeptics had earlier believed, a socialist command economy can function and even thrive.”)
- After that, the Left regrouped behind the environmentalist movement, but that now appears to be a spent force when it comes to mobilizing international consensus. The Kyoto Protocol — signed by President Clinton in 1998 (but never ratified by the U.S. Senate) — now appears to have been the high-water mark for the Global Warming movement (since coincidentally that was that last year of measured “warming”). Even those who believe global warming is a catastrophic, man-made
problem now struggle to make a case that global energy austerity is a practical or cost-effective course of action.

Will the Left be more successful behind the banner of “Inequality?” Credit them with placing a smart bet. Envy is a permanent feature of human nature. There’s a reason it made “God’s Top Ten List.” Coveting thy neighbor’s possessions is unhealthy for the individual and unhealthy for society. Envy historically has been used by demagogues to acquire tools of redistribution — tools that can be re-purposed to sustain political power. This underscores the importance of making our case.

Fortunately, I believe that — if we’re smart — the Inequality debate is eminently winnable by Classical Liberals. The next section explores different approaches we might take to the battlefield.

**We Can Win by Focusing on the Inequalities that Matter**

One response to Piketty is “so what?” It’s true that inequality tends to offend the sensibilities of many and trigger envy. But if we’re looking to develop a constructive solution, common sense would lead us to better define the problem. We want to focus on helping the folks at the bottom, right? Why prioritize punishing those at the top?

When we see a family in need, we care if they have shelter and clothing, running water, and food on the table. We don’t care whether or not their neighbor has a new car in her driveway.

Clearly, if we accept a social obligation to care for society’s least fortunate, the conversation begins and ends with the question, “How do we improve their absolute living standards?” Statistical measures of relative inequality are simply a distraction.

I always think of Margaret Thatcher’s last appearance as Prime Minister in the House of Commons, where she had the opportunity to expose the immorality of the redistributionist Left that focuses on this statistic rather than individuals’ actual well-being. You may have seen this clip on YouTube (search there for “Margaret Thatcher on Socialism”). MP Simon Hughes, a Liberal Democrat, acknowledged the “substantial success” of Thatcher’s reforms, but decried the widening gap between those in the top and bottom income deciles. Thatcher restates his argument with amazement: “He would rather the poor were poorer, provided the rich were less rich!”

Part of our task for seizing the intellectual high ground is to question why Inequality of Outcomes is relevant to anyone. Creating prosperity is clearly more important than creating equality.

We need to remind the public that those societies that embrace Inequality as a goal have a rotten record of achieving prosperity OR equality. The fact that these societies have failed the poor is evidenced in patterns of migration.
Ron Manners, a member of our Atlas Advisory Council and founder of the Mannkal Economic Education Foundation, put it eloquently recently when explaining what his Australian foundation aims to preserve in his native country:

“Australia is a relatively liberal society allowing individuals room to manage their own affairs within stable and certain law that avoids favouritism and protects life, liberty and property. As anyone may observe, these virtues are practiced most in countries to which refugees flee and least in countries from which they escape.”

It seems to me that we what we should be worried about is Inequality of access to good government.

Trying to help all countries develop free-society institutions is, of course, central to the Atlas Network mission. But I would argue that — within each of our respective countries — we see Inequalities among the politically connected and the rest of us.

This is worth railing against. We see it all the time:

• Examples of cronyism
• Abuses of the public trust for private benefit
• Regulatory capture that stifles economic competition
• Government spending that provides concentrated benefits to special interests, because they expect the costs, diffused across the entire taxpayer base, not to be noticed
• Eminent domain abuses in the name of politically-favored economic developers
• Monetary policy geared to propping up Wall Street (while hurting individual savers by reducing interest rates toward zero)
• Nanny state rules about how we should live our lives (and yet political elites seem to reliably exempt themselves from the rules they preach)

We — members of the freedom movement — should be the ones on offense here.

We are not defenders of the status quo. We champion all people to enjoy equality under the law, and we are sharp critics of privileges dispensed by those in power.

**The Weaknesses of Piketty’s Argument**

To be effective in making our case against “The Inequalities That Matter,” each of us ought to be well versed in the weaknesses of Piketty’s work. In this section, I have done my best to organize key arguments against his thesis and policy recommendations.

**Does the book contain data errors?**

Thomas Piketty admirably makes available his data available to the public. Chris Giles, economics editor at *The Financial Times*, identified a number of questionable instances in which Piketty made adjustments to the source data on which he relied. There has been a
lively back-and-forth about the judgment calls Piketty made, which may be of interest to some observers.

Similarly, Sarah Skwire and Steven Horwitz wrote an interesting article in *The Freeman* that takes issue with his use of “literary evidence” within *Capital in the Twenty-First Century*. (One of the striking things about the book is the frequent allusions to Balzac and Austen novels to deduce attitudes and understandings regarding economic inequality in their time periods.)

While these critiques are interesting, Classical Liberals may lose by arguing in the weeds. Whether Piketty has marshaled enough evidence to support his case is not as important as whether the case he makes matters.

*A Problem with No Solution; or a Solution to a Problem that Doesn’t Exist*

One angle that Piketty’s critics have (to my knowledge) neglected to mention is this: the solution Piketty proposes will have zero effect on the supposed problem that he measures. Piketty’s data focuses on income *before* the effects of taxes (that take resources from the rich) and government transfers (that provide resources to the poor). Piketty’s solution — taking more from the rich in taxes and providing more generous transfers to the poor — would have zero effect on the statistical problem as he defined it.

Extending from the previous point, if Piketty defined the problem differently, he might find no problem at all. When one factors in the effect of progressive taxation and a growing system of payments to low-income groups, the United States’ Gini coefficient — measuring income disparities — has remained fairly steady over the last three decades.

Moreover, Kevin Hassett of American Enterprise Institute has noted that the biggest factor driving wealth increases for the top 1% in the U.S. have been housing prices. Hassett says, “His theory that we’re going to substitute capital for labor falls apart in his own data, because the capital is all in housing and you can’t substitute a house for a worker.”

*Consumption Equality*

Returning to the theme I explored under “Exploring the Inequalities that Matter,” we ought to continue to emphasize how statistics regarding wealth inequality say nothing about living standards for the poor, and how this latter topic ought to be the focus of concern among the practical and well-intentioned.

Don Boudreaux has emphasized the growing “consumption equality” across society as an important, positive story — which tends to be neglected by observers and certainly by Piketty. Boudreaux writes:

> No principle of economics is more essential than the realization that, ultimately, wealth isn’t money or financial assets but, rather, ready access to real goods and services.
Piketty seems barely aware of this reality, focusing on differences in people’s monetary portfolios. He therefore ignores the all-important supply side: what people — rich, middle class, and poor — can buy with their money. Yet, to the extent that inequalities are at all relevant, the only ones that really matter are inequalities in access to real goods and services for consumption. Bill Gates’ living quarters are larger and more elegant than mine and, I dare say, yours. But even the poorest people in market economies have seen their ability to consume skyrocket over time. And the poorer they once were, the greater has been the enhancement of their ability to consume.

**The Rich are not a Static Group**

Joseph Schumpeter observed that “creative destruction” is a hallmark of free enterprise. Great profits may be followed by great losses. A 1956 essay by Ludwig Lachmann, excerpted in Tom Palmer’s *The Morality of Capitalism*, explains, “In a market economy a process of redistribution of wealth is taking place all the time...” based on of how knowledge is acquired and put to use to serve others’ needs.

Every few years, concerns bubble up about a successful company, perceived by some as “too powerful” and therefore a threat to the public interest. Fortunately, forces of competition have tempered whatever plans for world domination may have existed in the corporate offices of ITT, IBM and Microsoft. Apple, Google and Facebook surely will have their ambitions curtailed by new competitors too.

Similarly, there is a great deal of social mobility in free societies. The path to greater riches is seldom if ever clear, and there is constant turnover in lists of the world’s richest individuals. Human frailty being what it is, some will squander their wealth through excessive consumption. Some will make invest their assets poorly, and suffer great losses. Others make purposeful decisions (not accounted for at all in Piketty’s tome) to distribute their riches through philanthropy, rather than leave it to heirs. Some just make more money (serving customers, creating jobs), and that’s not a bad thing either!

Societies that show little social mobility tend to be those with strong political classes and low degrees of economic freedom. Unfree societies make it difficult to earn wealth except through politically granted privileges.

**Were the World Wars of the 20th Century a Good Thing?**

If we follow history as Piketty tells it, the problem of wealth inequality would be much worse, were it not for the period of 1914 to 1945. These years of course, provided “shocks” (e.g., two World Wars and the Great Depression) that you and I might consider horrible for the people killed and wealth destroyed.

Piketty finds a silver lining in that wars destroy massive amounts of capital, and therefore, create more equality.
Piketty does not seem like the kind of misanthrope who would root for another “reset” like World War II, but the logic of his argument would lead you to that conclusion. That is more than a little disturbing.

Does “r” really exist?

Piketty asserts that there exists a variable “r” that can define the investment return on “capital” — broadly construed as an aggregate of direct investments in productive capital, plus stocks and bonds and real estate and other speculative holdings. Tyler Cowen has challenged: “In too many parts of his argument, [Piketty] seems to assume that investors can reap such returns automatically, with the mere passage of time, rather than as the result of strategic risk-taking.”

The law of diminishing returns says that the more wealth we have, the harder it will be to find opportunities to achieve above-average returns. It is then unlikely that a risk-adjusted $r$ will race ahead of $g$ over time.

Do we really want “r” to be lower?

Achieving above-average returns tends to require risk-taking, betting on new ventures that are unproven. We ought to be cautious about reducing the incentives for such risk-taking — and capital investment in general. After all, when capital is accumulated and invested, the higher capital-to-labor ratio raises the marginal value created — and the wages that can be earned — by labor.

Does $r > g$ actually explain Income Inequality anyway?

NYU professor Debraj Ray — while sympathetic to Piketty’s goals in addressing income inequality — calls “$r > g$” a red herring. He points out that income inequalities are driven by economic shifts that rearrange what is rewarded by market forces. These shifts are numerous and over-lapping. A simple fact of life is that the rich can afford to have higher savings rates, and can afford to help their children obtain the human capital to succeed in a constantly-evolving market for talent. Ray says he would add another “fundamental Law of Capitalism” to Piketty’s work: “Uneven growth or not, there is invariably a long-run tendency for technical progress to displace labor.” He suggests, “To avoid the ever widening capital-labor inequality as we lurch toward an automated world, all its inhabitants must ultimately own shares of physical capital.”

How to Help the Poor Own the Means of Production

Prof Ray’s critique of Piketty seems to point us in a healthy direction. It is sensible to worry the poor will be left-behind, because they do not have the resources to adapt to changes in the global market economy, and because their consumption needs inhibit their ability to save (and achieve “r” returns that Piketty posits will be greater than the growth they will see in their wages).
Perhaps we should look for ways to help them “participate in the benefits of having capital” (to use a phrase of the Cato Institute’s Michael Tanner). Tanner suggests the obvious solution is to reform policies like Social Security, so that the poor can own their own investment account for retirement.

Sir John Templeton, the great investor, philanthropist, and mutual fund pioneer, saw that capitalism created innovations that would allow the poor to acquire ownership stakes in “the means of production” without the proletariat revolution predicted by Marx. In an unpublished paper from the 1960s, Templeton discussed how the then-recent innovation of mutual funds made it much easier for individuals of modest means to participate in financial markets.

What Causes Economic Growth After All?

Economic growth is driven by entrepreneurial insights that increase productivity or open up entirely new vistas for value creation. The emergence of these insights (and the even harder job of bringing them to market) depends on incentives that the returns will be great enough to justify the risks. You might say that they depend on the promise of “unequal outcomes.”

One paragraph toward the end of Piketty’s book — as he sets up his proposed policy solution — sees him acknowledge the risk of disincentivizing capital investment and entrepreneurship:

“To be sure, one could tax capital income heavily enough to reduce the private return on capital to less than the growth rate. But if one did that indiscriminately and heavy-handedly, one would risk killing the motor of accumulation and thus further reducing the growth rate.”

Piketty uses this argument against taxing income to justify taxing wealth. I am skeptical such a distinction matters.

In both cases, resources are taken from private sector hands and placed in the hands of government. That is, from hands that would be incentivized to invest them productively, to hands that respond to political pressures.

One of the blind spots of many on the Left is in thinking that the rich “control” wealth in a way that hurts the rest of society. Ian Murray has called this “the Smaug fallacy” in honor of the dragon that sleeps atop a pile of stolen gold in JRR Tolkein’s The Hobbit. The rich do not resemble Smaug in hoarding their riches; their consumption provides demand-side benefits to the economy, and their investments power new enterprises and lower the costs of capital.

One might argue that governments can do similar things, but as a general rule, you can trust that they will be less thoughtful in what they do. After all, government decision-
makers rarely suffer negative consequences for misallocating resources (or receive personal rewards for making brilliant decisions). You might recall Milton Friedman’s aphorism: "Nobody spends somebody else’s money as carefully as he spends his own."

Who Would Administer a Massive Global Tax and Redistribution Scheme?

Here is where common sense undoes whatever faith a reader might continue to have in Piketty’s case. If you satisfy yourself that the questions concerning Piketty’s data are immaterial, and if you maintain that wealth inequality is a legitimate concern, and if you are willing to risk the dangers of disincentivizing the pursuit of “r” upon which “g” depends… then you still must cross the bridge: does Piketty have a credible solution?

I simply cannot imagine having such unquestioning faith in the beneficence and competence of government authorities to trust them to administer a global tax on capital.

Piketty gently hedges against the bet he advocates: "Before we can learn to efficiently organize public financing equivalent to two-thirds to three-quarters of national income, it would be good to improve the organization and operation of the existing public sector…"

Here is Don Boudreaux’s appropriately snarky rejoinder:

“It would indeed be "good" to make such improvements. I’d like to imagine that, if Karl Marx were alive today, he’d sadly inform his less-experienced colleague that, 150 years ago, socialists had that very same idea. It did not work out as hoped.

What about the role of institutions in society?

Daron Acemoglu (MIT) and James A. Robinson (Harvard) critiqued Piketty for failing to factor in the institutional factors that are more plausible causes of inequality in most societies. Their study of the economic and political histories of South Africa and Sweden, show that it’s dangerous to posit inexorable “laws of capitalism” when there are massive differences, from society to society, in how inclusive the economic system is.

This leads us back to where I really believe Classical Liberals can win the argument on “The Inequalities that Matter.”

Our philosophy is one of inclusion. We stand up for the legal equality of every person.

Resentment of inequality is not unjustified when it is fostered by government privileges. In a recent Forbes piece, Atlas Network’s Alex Chafuen noted:

“The term “crony capitalism” is being used today by economists from all sides of the ideological spectrum. It usually refers to an economy where preferential regulation and other favorable government intervention — based on personal relationships — helps decide winners and losers.”
Friends of the free society need to be vigilant in critiquing the cronyism and the private interests that are complicit in it. Understandably, the public will not embrace a general defense of “capitalism,” if what they observe as capitalism is a collusion between big business and government — instead of true free enterprise.

We can also better frame our initiatives that would produce better outcomes in areas of health and education, by removing government interference in those markets, as efforts to remedy inequalities that afflict society’s less fortunate. Piketty himself pointed to the primacy of education among the factors that can improve the situation of those at the bottom with regard to the wealth distribution. In his interview with Russ Roberts on EconTalk, he asserted:

“At the end of the day, the main policy to reduce inequality is not progressive taxation, is not the minimum wage. It is really education. It is really investing in skills and investing in schools.... The primary mechanism to reduce inequality in the long-run is the diffusion of knowledge, the diffusion of skills, the diffusion of higher productivity.”

Classical liberals can win this argument. We are the ones who aim to remove barriers to self-improvement that currently hurt the poor. We see no benefit in creating a dependent class, or protecting a privileged one. We advocate for a more robust civil society that can help overcome the social stratification that, as Charles Murray and others have observed, is increasingly accompanying the economic stratifications of society.

More than a threat, Piketty’s Charge represents an opportunity for a strong counter-attack, and for winning a new victory for liberty.
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