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How Piketty Misses The Point

Deirdre N. McCloskey

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Thomas Piketty has written a big book — 577 pages of text; 76 pages of notes; 115 charts, tables, and graphs — that has excited the left worldwide. First published in French in 2013, an English edition was issued last year to wide acclaim and a top position on the New York Times bestseller list. It has been a long time since a technical treatise on economics has had such a market. An economist can only applaud. And an economic historian can only wax ecstatic.

Piketty's central theme is the force of interest on inherited wealth causing, he claims, increasing inequality of the income earned from the wealth. In 2014 he declared to the BBC's Evan Davis that "money tends to reproduce itself," a complaint about money and its interest rate repeatedly made in the West since Aristotle. As the philosopher said of some men, "the whole idea of their lives is that they ought either to increase their money without limit, or at any rate not to lose it… . The most hated sort [of increasing their money]… is usury, which makes a gain out of money itself."

Piketty's theory is that the yield on capital usually exceeds the growth rate of the economy, and so the share of capital's returns in national income will steadily increase, simply because interest income is growing faster than the income the whole society is getting. Let us therefore bring in the government to implement "a progressive global tax on capital" — to tax the rich. It is, he says, our only hope. Reading the book is a good opportunity to understand the latest of the leftish worries about capitalism, and to test its economic and philosophical strength. Piketty's worry about the rich getting richer is indeed merely the latest of a long series going back to Thomas Malthus, David Ricardo, and Karl Marx. Since those founding geniuses of classical economics, trade-tested progress has enormously enriched large parts of humanity — which is now seven times larger in population than in 1800 — and bids fair in the next 50 years or so to enrich everyone on the planet. And yet the left routinely forgets this most important secular event since the invention of agriculture — the Great Enrichment of the last two centuries — and goes on worrying and worrying in a new version every half generation or so.

All the worries, from Malthus to Piketty, share an underlying pessimism, whether from imperfection in the capital market or from the behavioral inadequacies of the individual consumer or from the Laws of Motion of a Capitalist System. During such a pretty good history from 1800 to the present, the economic pessimists on the left have nonetheless been subject to nightmares of terrible, terrible faults. Admittedly, such pessimism sells. For reasons I have never understood, people like to hear that the world is going to hell, and become huffy and scornful when some idiotic optimist intrudes on their pleasure. Yet pessimism has consistently been a poor guide to the modern economic world.

Supply, demand and creative destruction

The technical flaws in Piketty's argument are pervasive. When you dig, you find them. The fundamental problem is that Piketty does not understand how markets work. In keeping with his position as a man of the left, he has a vague and confused idea about how supply responds to higher prices. Startling evidence of Piketty's miseducation occurs as early as page 6.

He begins by seeming to concede to his neoclassical opponents: "To be sure, there exists in principle a quite simple economic mechanism that should restore equilibrium to the process: the mechanism of supply and demand. If the supply of any good is insufficient, and its price is too high, then demand for that good should decrease, which would lead to a decline in its price." The words I italicize clearly mix up movement along a demand curve with movement of the entire curve, an error of first-term college students. The correct analysis is that if the price is "too high" it is not the whole demand curve that "restores equilibrium," but an eventually outward-moving supply curve. The supply curve moves out because entry is induced by the smell of super-normal profits.

Piketty does not acknowledge that each wave of inventors, entrepreneurs, and even routine capitalists find their rewards taken from them by entry. Look at the history of fortunes in department stores. The income from department stores in the late 19th century, in Le Bon Marché, Marshall Field, and Selfridge's, was entrepreneurial. The model was then copied all over the rich world. In the late 20th century the model was challenged by a wave of discounters, and they then in turn by the internet. What happens is that the profit going to the profiteers is more or less quickly undermined by outward-shifting supply. The original accumulation dissipates. The economist William Nordhaus has calculated that the inventors and entrepreneurs nowadays earn in profit only 2 percent of the social value of their inventions. If you are Sam Walton the 2 percent gives you personally a great deal of money from introducing bar codes into stocking of supermarket shelves. But 98 percent at the cost of 2 percent is nonetheless a pretty good deal for the rest of us. The gain from macadamized roads or vulcanized rubber, then modern universities, structural concrete, and the airplane, has enriched even the poorest among us.

Human capital and inequality

This brings me to the next technical problem. Piketty's definition of wealth does not include human capital, owned by the workers, which has grown in rich countries to be the main source of income, when it is combined with the immense accumulation since 1800 of capital in knowledge and social habits, owned by everyone with access to them. Once upon a time, Piketty's world without human capital was approximately our world, that of Ricardo and Marx, with workers owning only their hands and backs, and the bosses and landlords owning all the other means of production. But since 1848 the world has been transformed by what sits between the workers' ears.

The only reason in the book to exclude human capital from capital appears to be to force the conclusion Piketty wants to achieve. One of the headings in Chapter 7 declares that "capital [is] always more unequally distributed than labor." No it isn't. If human capital is included — the ordinary factory worker's literacy, the nurse's educated skill, the professional manager's command of complex systems, the economist's understanding of supply responses — the workers themselves, in the correct accounting, own most of the nation's capital — and Piketty's drama falls to the ground.

Finally, as he candidly admits, Piketty's own research suggests that only in the United States, the United Kingdom, and Canada has income inequality increased much, and only recently. In other words, his fears were not confirmed anywhere from 1910 to 1980; nor anywhere in the long run at any time before 1800; nor anywhere in Continental Europe and Japan since World War II; and only recently, a little, in the United States, the United Kingdom, and Canada. That is a very great puzzle if money tends to reproduce itself as a general law. The truth is that inequality goes up and down in great waves, for which we have evidence from many centuries ago down to the present, which also doesn't figure in such a tale.

Sometimes Piketty describes his machinery as a "potentially explosive process." At other times, he admits that random shocks to a family fortune means that "it is unlikely that inequality of wealth will grow indefinitely … rather, the wealth distribution will converge toward a certain equilibrium." On the basis of the Forbes lists of the very rich, Piketty notes, for example, "several hundred new fortunes appear in [the $1 billion to $10 billion] range somewhere in the world almost every year." Which is it, Professor Piketty? Apocalypse or a steady share of rich people constantly dropping out of riches or coming into them, in evolutionary fashion?

The science writer Matt Ridley has offered a persuasive reason for the slight rise in inequality recently in Britain. "Knock me down with a feather," Ridley writes:

You mean to say that during three decades when the government encouraged asset bubbles in house prices; gave tax breaks to pensions; lightly taxed wealthy non-doms [that is, "non-domiciled," the citizens of other countries such as Russia and Saudi Arabia living in the U.K.]; poured money into farm subsidies; and severely restricted the supply of land for housing, pushing up the premium earned by planning permission for development, the wealthy owners of capital saw their relative wealth increase slightly? Well, I'll be damned… . [Seriously, now] a good part of any increase in wealth concentration since 1980 has been driven by government policy, which has systematically redirected earning opportunities to the rich rather than the poor. In the United States, one can make a similar case that the government, which Piketty expects to solve the alleged problem, is in fact the cause.

Is inequality bad?

The central problem with the book, however, is an ethical one. Piketty does not reflect on why inequality by itself would be bad. To be sure, it's irritating that a super rich woman buys a $40,000 watch. The purchase is ethically objectionable. She should be giving her income in excess of an ample level of 2 cars, say, not 20; 2 houses, not 7; 1 yacht, not 5 — to effective charities. Andrew Carnegie enunciated in 1889 the principle that "a man who dies thus rich dies disgraced." Carnegie gave away his entire fortune. (Well, he gave it at death, after enjoying a castle in his native Scotland and a few other baubles.) But the fact that many rich people act in a disgraceful fashion does not automatically imply that the government should intervene to stop it. People act disgracefully in all sorts of ways. If our rulers were assigned the task in a fallen world of keeping us all wholly ethical, the government would bring all our lives under its fatherly tutelage, a nightmare achieved approximately before 1989 in East Germany and now in North Korea.

Notice that in Piketty's tale the rest of us fall only relatively behind the ravenous capitalists. The focus on relative wealth or income or consumption is one serious problem in the book. Piketty's vision of apocalypse leaves room for the rest of us to do very well indeed — rather non-apocalyptically — as in fact since 1800 we have. What is worrying Piketty is that the rich might possibly get richer, even though the poor get richer, too. His worry is purely about difference, about a vague feeling of envy raised to a theoretical and ethical proposition.

But our real concern should be with raising up the poor to a condition of dignity, a level at which they can function in a democratic society and lead full lives. It doesn't matter ethically whether the poor have the same number of diamond bracelets and Porsche automobiles as do owners of hedge funds. But it does indeed matter whether they have the same opportunities to vote or to learn to read or to have a roof over their heads.

Adam Smith once described the Scottish idea as "allowing every man to pursue his own interest his own way, upon the liberal plan of equality, liberty and justice." It would be a good thing, of course, if a free and rich society following Smithian liberalism produced a Pikettyan equality. In fact, it largely has, by the only ethically relevant standard of basic human rights and basic comforts. Introducing liberalism in Hong Kong and Norway and France, for instance, has regularly led to an astounding betterment and to a real equality of outcome — with the poor acquiring automobiles and hot-and-cold water at the tap that were denied in earlier times even to the rich, and acquiring political rights and social dignity that were denied in earlier times to everyone except the rich.

The economists Xavier Sala-i-Martin and Maxim Pinkovsky report on the basis of detailed study of the individual distribution of income — as against comparing distributions nation-by-nation — that "world poverty is falling. Between 1970 and 2006, the global poverty rate has been cut by nearly three quarters. The percentage of the world population living on less than $1 a day (in PPP adjusted 2000 dollars) went from 26.8% in 1970 to 5.4% in 2006."

In 2013 the economists Donald Boudreaux and Mark Perry noted that "according to the Bureau of Economic Analysis, spending by households on many of modern life's 'basics' — food at home, automobiles, clothing and footwear, household furnishings and equipment, and housing and utilities — fell from 53 percent of disposable income in 1950 to 44 percent in 1970 to 32 percent today."

The economist Steven Horwitz summarizes the facts on labor hours required to buy a color TV or an automobile, and notes that "these data do not capture … the change in quality … . The 1973 TV was at most 25 inches, with poor resolution, probably no remote control, weak sound, and generally nothing like its 2013 descendant … . Getting 100,000 miles out of a car in the 1970s was cause for celebration. Not getting 100,000 miles out of a car today is cause to think you bought a lemon." He observes further that "looking at various data on consumption, from Census Bureau surveys of what the poor have in their homes to the labor time required to purchase a variety of consumer goods, makes clear that poor Americans are living better now than ever before. In fact, poor Americans today live better, by these measures, than did their middle class counterparts in the 1970s."

The political scientist and public intellectual Robert Reich argues that we must nonetheless be alarmed by inequality, rather than devoting all our energies to raising the absolute condition of the poor. "Widening inequality still hampers upward mobility," he declares. Reich is mistaken. Horwitz summarizes the results of a study by Julia Isaacs on individual mobility from 1969 to 2005: "82% of children of the bottom 20% in 1969 had [real] incomes in 2000 that were higher than what their parents had in 1969. The median [real] income of those children of the poor of 1969 was double that of their parents." There is no doubt that the children and grandchildren of the Dust Bowl refugees in California, for example, are much better off than their fathers or grandfathers. John Steinbeck chronicled in The Grapes of Wrath their worst and terrible times. A few years later many of the Okies got jobs in the war industries, and many of their children later went to university. Some then went on to become university professors who think that the poor are getting poorer.

The main event: the great enrichment

The most fundamental problem in Piketty's book, then, is that he misses the main act. In focusing solely on the distribution of income, he overlooks the most surprising secular event in history: the Great Enrichment of the average individual on the planet by a factor of 10 and in rich countries by a factor of 30 or more. Many humans are now stunningly better off than their ancestors were.

This includes a gigantic improvement of the poorest — your ancestors and mine. By dramatic increases in the size of the pie, the poor have been lifted to 90 or 95 percent of equal sustenance and dignity, as against the 10 or 5 percent attainable by redistribution without enlarging the pie.

What caused the Great Enrichment? It cannot be explained by the accumulation of capital, as the very name "capitalism" implies. Our riches were not made by piling brick upon brick, bachelor's degree upon bachelor's degree, bank balance upon bank balance, but by piling idea upon idea. The bricks, BAs, and bank balances were of course necessary. Oxygen is necessary for a fire. But it would be unenlightening to explain the Chicago Fire of 1871 by the presence of oxygen in the earth's atmosphere.

The original and sustaining causes of the modern world were indeed ethical, not material. They were the widening adoption of two new ideas: the liberal economic idea of liberty for ordinary people and the democratic social idea of dignity for them. This, in turn, released human creativity from its ancient trammels. Radically creative destruction piled up ideas, such as the railways creatively destroying walking and the stage coaches, or electricity creatively destroying kerosene lighting and the hand washing of clothes, or universities creatively destroying literary ignorance and low productivity in agriculture. The Great Enrichment requires not accumulation of capital or the exploitation of workers but what I call the Bourgeois Deal. In the historical lottery the idea of an equalizing liberty and dignity was the winning ticket, and the bourgeoisie held it.

That even over the long run there remain some poor people does not mean the system is not working for the poor, so long as their condition is continuing to improve, as it is, and so long as the percentage of the des-perately poor is heading toward zero, as it is. That people still sometimes die in hospitals does not mean that medicine is to be replaced by witch doctors, so long as death rates are falling and so long as the death rate would not fall under the care of the witch doctors. It is a brave book Thomas Piketty has written. But it is mistaken.