Beyond Piketty’s *Capital*:

*What Ben Franklin and Billie Holiday Could Tell Us About Capitalism’s Inequalities*

by Michael Harrington,

It has now been two years since French economist Thomas Piketty published his tome, *Capital in the Twenty-First Century*, and one year since it was published in English, raising a fanfare of praise and criticism. It has deserved both, most notably for “putting the distributional question back at the heart of economic analysis.”¹ I would imagine Professor Piketty is also pleased by the attention his work has garnered: What economist doesn’t secretly desire to be labeled a “rock-star” without having to sing or pick up a guitar to demonstrate otherwise?

Piketty’s study (a collaborative effort, to be sure) is an important and timely contribution to economic research. His datasets across time and space on wealth, income, and inheritances provide a wealth of empirical evidence for future testing and analysis. The presentation is long, as it is all-encompassing, tackling an ambitious, if not impossible, task. But for empirics alone, the work is commendable.

Many critics have focused on methodology and the occasional data error, but I will dispense with that by accepting the general contour of history Piketty presents as accurate of real trends in economic inequality over time. And that it matters. Inequality is not only a social and political problem, it is an economic challenge because extreme disparities break down the basis of free exchange, leading to excess investment lacking productive opportunities.² (Piketty ignores the natural equilibrium correctives of business/trade cycles, presumably because he perceives them as interim reversals on an inevitable long term trend.) I have followed Edward Wolff’s research long enough to know there is an intimate causal relationship between capitalist markets and material outcomes. I believe the meatier controversy is found in Piketty’s interpretations of the data and his inductive theorizing because that tells us what we can and should do, if anything, about it. Sufficient time has passed for us to digest the criticisms and perhaps offer new insights.

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¹ Distributional issues are really at the heart of our most intractable policy challenges. Not only are wealth and income inequalities distributional puzzles, so are hunger, poverty, pollution, the effects of climate change, etc. Unfortunately, the profession tends to ignore distributional puzzles because the necessary assumptions of high-order mathematical models that drive theory rule out dynamic network interactions that characterize markets. Due to these limitations, economics is left with the default explanations of initial conditions, hence the focus on natural inequality, access to education, inheritance, etc. General equilibrium theory (GE) also assumes distributional effects away: over time prices and quantities will adjust to correct any maldistributions caused by misallocated resources. For someone mired in poverty or hunger, it’s not a very inspiring assumption.

² As opposed to distributional problems, modern economics is very comfortable studying and prescribing economic growth. Its mathematical models provide powerful tools to study and explain the determinants of growth. This is why growth is often touted as the solution to every economic problem. (When you’re a hammer, everything looks like a nail.) But sustainable growth relies on the feedback cycle within a dynamic market network model, so stable growth is highly dependent on sustainable distributional networks.
The data show that inequality in both wealth and income varies over time, yet reveal persistent patterns of divergence and convergence. To explain, Piketty’s offers his “fundamental force for divergence” where, over the long run, the rate of return on capital \((r)\) exceeds the growth rate \((g)\) of national income or output (which are statistically equivalent). In arithmetic short-hand, \((r > g)\). This implies capital income accumulates and accrues increasingly to those who own and control capital.

This insight is unremarkable in itself, as one can perceive how it illustrates the material success of private market-based capitalism as an economic system. One would suppose the opposite relation \((r < g)\) illustrates alternative systems, such as feudalism or collectivism. These would also include the more recent experiments in economic organization called fascism, communism, socialism, and perhaps even, if I dare speak such heresy, certain inefficient cases of “social democracy” as some ideal mix of socialism and capitalism.

We can imagine how the world would look if \(r\) did not exceed \(g\). Perhaps we would still be scraping a living from the soil using pick axes and shovels? What we’re getting at is that capital accumulation is what leverages our labors to raise our standard of living. The following graph of capital vs. income (GDP) per worker by country should make this clear.

![Graph of capital vs. income (GDP) per worker by country](image)

Source: David N. Weil, “Understanding Economic Growth.”

If one has further doubts, it may be enough to look at the hockey stick graph of economic development in per capita GDP that took off after 1700 under capitalist economic relations. (One must also give equal credit to the accompanying idea of liberty that encouraged capitalist societies to flourish.)
Thus, capital accumulation has a positive effect on growth, whereas the concentration of the returns to capital may be seen negatively for promoting inequality. Recognizing the fact that capital concentrates is not exactly a new discovery. More than two centuries before Piketty was born, Ben Franklin was said to have quipped, “Money makes money and the money money makes makes more money.” (My spellchecker wreaks havoc with that sentence.)

Many of Piketty’s free market critics contend whether this is truly a policy issue. They cite income mobility and the churning of capital over time through “rags to riches to rags in three generations.” Others cite the incredible absolute gains low income people have reaped under capitalism, comparing the economic security, modern conveniences, and wealth of choices facing the modern-day poor to the nobility three centuries ago. I believe Piketty’s answers to such criticisms hold weight, and I concede this as a strong advocate of free markets (one can be a strong advocate of free markets even if pure free markets don’t exist – the ideal is a theoretical lodestar).

The dynamics of modern capitalism suggest that income mobility is becoming increasingly constrained, despite the volatility of wealth associated with technology and finance. Piketty does make a convincing case that, unchecked, inheritance and demographics will impede mobility in the future. I would also argue that, in the frame of a lifetime, relative wealth most certainly does matter in a world of scarce resources, especially when we incorporate the politics. A focus on relative wealth is more than an expression of envy: Being a grade school teacher, or even a professor, in Silicon Valley is no simple proposition when it comes to the cost of living or buying a house. More problematic for Prof. Piketty is his under-appreciation for how market competition works and how the basic dynamics of prices and quantities calibrate markets.³

As an analytical precept, Piketty’s simple \((r > g)\) based on national aggregates is too broad a brush to examine the necessary details. First, capital income is a component of national income, so \(r\) is contained in \(g\). Economic growth is a function of population growth, capital accumulation, and technological innovation through the productive synergy of these three factors. We enhance wealth creation by leveraging labor with capital and other resources to increase output. This suggests that the higher \(r\) we have, the greater \(g\) will be. Politicians, for want of new ideas, focus policy on increasing \(r\) in order to increase \(g\). How often have we heard them exhort business investment and tax incentives to jump-start growth and job creation? This is also why they resist taxing capital. Empirical data, and logic, show that \(r\) is much more volatile and fickle than \(g\). The return on capital varies widely and can quickly go negative (\(r\) in Piketty’s usage is actually a measure of the market value of capital, which can be highly volatile in response to the supply and demand for credit). This is why Piketty needs his qualifier “in the long run.” But politics and policy are short term and can have a direct and immediate effect on \(r\), independent of \(g\). (Long runs are also made up of many short runs, and, as Keynes quipped, “In the long run we are all dead.”)

Historically, Piketty notes this reversal in \(r\) for the period 1913-1950, citing the damaging effects of two world wars and a Great Depression. Piketty infers this time period was a singular catastrophe and that \(r > g\) is inevitable, but the 20th century can hardly be the anomaly in the history of markets. What about the Dark Ages? Did the decline of \(r\) contribute to the collapse of

the Pax Romana, or vice-versa? What about the Hundred Years War, or the Black Death? (Though these periods predate capitalism per se, they were still characterized by capital, labor, and exchange markets.)

More recently, how did r track g through the 2008 financial crisis? It would appear that there are numerous reversals to capital accumulation that we can attribute to political, social, and economic upheavals. If one looks at the trend of wealth for the top decile of the population, there appear to be many such episodes, mostly associated with economic shocks, recessions, and depressions. One could make a facetious suggestion that if we really wanted to flatten wealth and incomes fast, what’s required is the Mother of all Global Depressions. But let’s not be flippant.

Piketty correctly identifies the bête noire of capitalism as the extreme concentration of capital ownership to which capital income accrues. Capital is defined as any asset that has the potential to yield income, including profits, dividends, interest, rents, trading gains, intellectual property rights, etc. Capital income not only drives the divergence in wealth, but also contributes much to income inequality as most corporate compensation is undergirded by excess returns generated by the synergies of capital.

How do we understand the factors that influence the return on capital and its underlying distribution? This is a big question, and Piketty doesn't adequately address it because his historical data glosses over the details. Instead, Piketty succumbs to the siren song of Marxism and its stark division between capital and labor, where labor is the creation of all value and capital is the expropriation of surplus labor value. Thus he delivers this astounding statement, “…there is something astonishing about the notion that capital yields rent, or income that the owner of capital obtains without working.”

Prof. Piketty seems to have missed the “fundamental law of finance capital” (as opposed to capitalism): reward (profit) is a return to risk and the relationship is proportional. He flirts with this concept once or twice: “Capital is never quiet: it is always risk-oriented and entrepreneurial…,” but he never experiences the necessary breakthrough. He explicitly states that “payment to capital for no work is a crucial question,” but one he is not asking here. This is unfortunate because, as I will argue, it steers him away from workable solutions to address the concentration of capital. It also perpetuates much of the misunderstanding that animates class antagonism and ideological conflict.

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4 The dominant form of capital has varied over time, mainly land in the past but under industrialism was comprised mostly of physical and finance capital. Over the past century, with the integration of a global market, finance has come to dominate wealth and power – a fact that came all too apparent at the turn of this century. To hone in on economic inequality today we need to focus on finance capital. Piketty also assigns human capital to labor incomes due to data constraints, but I believe this blurs his argument since capital is capital and we use education to spur human capital. More importantly, in the information age we need to include the ownership and control of information data. Apple and Google are not the most highly valued companies in the world by accident.

5 His analysis of capital and labor expose the closet Marxist, though he is loath to admit it. But we should dispense with the knee-jerk reactions to the mere mention of Marx that incites so much ideological rancor. Maybe we can just think of his first name as Groucho.
Finance capital is a factor of production; it is put at risk of loss and for that it must be paid. (The word risk will pop up time and time again because it is key to understanding how capitalism really works.) In most capitalist enterprises, labor and other resource inputs are contracted before production. In a dynamic world of uncertainty, where future outcomes are unknown and merely estimated, new investment entails considerable risk of loss. If the venture fails, other inputs are still paid for services rendered, but the “capitalist” absorbs the entire loss. Wage contracts assign financial risk to employers and thereby assign the concomitant returns of success to the employer. *A priori* risks, then, are *not* evenly distributed; consequentially, neither are *a posteriori* returns.

Risk-taking demands that the capitalist receive payment as the residual claimant to compensate for the risk of loss and the carrying costs of investment finance. If the risk-taker cannot expect profit, the capital investment will never be made and other inputs will be rendered idle, i.e., unemployed. If the enterprise is successful, the employer can then decide if she wants to reinvest in future production, pay bonuses to workers, or withdraw her capital and close up shop. This is how financial markets work to diversify risk and provide capital to entrepreneurs. (This bears emphasis: capitalism’s saving grace is that it makes risk management and adaptation to change more efficient and profitable, generating all those wonderful material rewards.)

Furthermore, simple business accounting illustrates the crucial difference between the distributions to capital and labor. Profit equals total revenues minus costs ($P = TR - c$), where input costs include wages and the costs of capital. Suppliers of capital either provide debt or equity finance, where those that provide riskier equity finance obtain a legal claim to a share of the residual profits. The survival imperative of successful capitalist enterprise is to expand revenues while minimizing costs, so there is constant pressure to maximize profit by minimizing wages and the cost of capital. Alternatively, one might increase revenues by expanding markets (globalization) or raising productivity, but higher labor productivity means more product produced by *less* labor. Thus, successful business will tend to either raise wages or employment, but not both. In a declining business environment it may be forced to reduce both, *at least in the short run, holding other factors constant*.

We see from this simple logic that profits (as a return to equity capital) and wages (as a return to labor) reside on opposite sides of the capitalist accounting equation. As wages go up, profits go down, and vice versa (again, holding other factors constant). Profits accrue to residual claimants which include proprietors and investors who have legal claim to the returns to capital retained by the enterprise (as stated above, labor contracts usually surrender any such claims as a trade-off for being paid before production, while debt is repaid after production but before equity owners).

We should understand from this simple accounting that the logic of *successful* capitalism will serve to widen the inequality gap between owners of capital and labor. This is the very problem we would hope to mitigate, but without making capitalism unprofitable.

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*Cronyism is when ownership claims are manipulated so returns are uncoupled from risks. This yields the so-called “privatization of reward and socialization of risk,” or the more infamous gamble, “heads we win, tails you lose.” The less obvious case is when the unemployed shoulder all the income losses of the labor force, a risk for which they were never adequately paid.*
One can only surmise that such insights elude economists without an intimate knowledge of finance and business accounting. By the direction he takes, I must count Piketty in that camp. Instead, Piketty develops an interesting macro story that helps explain the historical trends on inequality. Without getting into the mathematics of his methodology (which for an economist is not that complex, his equations are definitional, rather than theoretical), Piketty observes that societies where the savings rate exceeds the growth rate will begin to accumulate more capital, which will become more concentrated over time, capturing an increasing share of national income. This helps explain developed societies, like Japan, most of Europe and, to a certain extent, the United States, where incomes of the capitalist class will be saved and reinvested to serve demand from emerging markets, leading to ever greater accumulation. He also notes the effect aging demographics will have on wealth concentration through narrowed inheritance.

However, high savings rates often accompany high growth rates, such as we have observed over the past thirty years in emerging economies in Southeast Asia, China, India and Brazil. These societies have been self-financing growth with domestic savings. China’s savings rate hovers around 50% of income, but it’s growth rate over the past thirty years has averaged between 8% and 10% with a rapidly growing middle class. Piketty attributes this to a catch-up phase for poorer countries that will converge with rich countries as emerging economies develop, but this is exactly what we applaud in capitalism: the ability for the poor to close income and wealth gaps by developing markets. Piketty’s critics have noted that inequalities among nations have been reduced as global poverty rates have plunged and new middle classes emerge in these countries. This contrasts starkly with previous strategies of state-directed investment under socialist pretenses.

So it matters whether the savings rate is high because investment opportunities defer consumption or because an aging society is seeking greater financial security. Piketty admits this explicitly: “…savings behavior and attitudes toward the future cannot be encapsulated in a single parameter. These choices need to be analyzed in more complex models, involving not only time preference but also precautionary savings, life-cycle effects, the importance attached to wealth in itself, and many other factors.” China will certainly be a test case as its aging demographic fights against the desire to grow. Savings rates will need to come down to drive domestic demand and restrain excess investment reflected today in real estate speculation and ghost cities.

In Piketty’s view, inheritance unfairly widens these gaps in wealth and income over time, where the rich tend to become rentiers, “more and more dominant over those who own nothing but their labor. Once constituted, capital reproduces itself faster than output increases.” Absent changes in policy, Piketty projects a dismal future where democracy is threatened by such a widening gap between a rich elite and an impoverished middle class that social, political, and economic breakdown is inevitable. In an existential sense he says, “The past devours the future.”

We should question this dire prognosis. First, the idea that ‘capital returns outstrip output’ does not go on forever. If it did the biggest capitalist would have swallowed the world long ago. So something (declining marginal returns to capital?) forces the growing gap between r and g to close. We should also ponder his overly negative view of inheritance. I would imagine many of us view inheritance as insuring a birthright of economic security to our offspring and future

descendants. Likely, most of us feel a responsibility to the well-being of our progeny and in this sense cannot view inheritance but as a good. This would include gifting, which Piketty also views negatively. He should know from studies of economic behavioralism and decision-making that humans are highly sensitive to the risks of potential loss, much more so than to potential gain. In other words, we are much more concerned with not losing what we have than in gaining something we lack. For survival of the organism, this makes perfect evolutionary sense.

We also have argued that capital accumulation has a positive affect on growth, so why would we want to denigrate it? Lastly, an aging society faces an inevitable need to increase the capital (rentier) share of national income. Most people in the last third of their lives aren’t going to be starting new businesses to increase their wealth.

The real problem with inheritance is not accumulation, but again, the intergenerational concentration effect, especially at the extreme. We should be concerned with winner-take-all outcomes (and incomes) and concentrations of intergenerational wealth, but Piketty’s fatalism leads us into a cul-de-sac. The only remedy he sees is a redistributive mechanism that increases progressive taxes on capital wealth and income on a global scale. He concedes this as a utopian ideal that, due to the concentration of power and divergent political interests, has little chance of ever being realized. Politically speaking, Piketty and his followers have reached a dead end.

Viewed differently, I think Piketty has taken a wrong turn. As we established earlier, politics and policy matter. The apocalypse Piketty foresees can be partly attributed to poorly designed policies that exacerbate inequality and narrow capital ownership. Let us restate the problem simply: capital concentrates wealth and income, widening the gap between those who own and control capital relative to those who don’t. (The meaningful form of capital being finance capital.)

Piketty’s longitudinal data on wealth and incomes show a very strong correlation between inequality and financial policy. Specifically, inequality exploded in the 1920s and the years after 1990 up to the present. These time periods are synonymous with the extreme financial bubbles of the Roaring Twenties and the recent boom in financial asset markets associated with easy credit policy and ballooning debt leverage. Piketty wants to make the case that these episodes were due to tax cuts for the rich, but the data correlations are unconvincing. Not surprisingly, both booms ended quite abruptly with market crashes and reversals in inequality. This should suggest that misguided financial policies, specifically by central banks, may be an important factor shaping Piketty’s future projections. We can change these policies.

Other critics of Piketty’s analysis have focused on the residual not explained by financial asset volatility and found it mostly explained by rapidly rising housing values in the period after 1970. These are also the result of government housing policies that have amplified demographic trends. The mortgage crisis of 2008 was a clear indication of something amiss in housing policy, yet easy credit policy and asset reflation are both still with us driving inequality.

Certainly there are ways to deal with this without killing the goose that lays the golden eggs. Perhaps we can put this more plainly by asking the million-dollar question: if capitalists are so

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8 See Rognlie, op. cit.
successful, why aren’t we all striving to become capitalists? And why isn’t the state trying to help us achieve that? Billie Holiday said it best with the lyrics to her song *God Bless the Child*:

> Them that's got shall have,
> Them that's not shall lose,
> So the Bible says and it still is news.
> Mama may have, Papa may have,
> But God bless the child that's got his own, that's got his own.

This gets us back to the crux of the problem of inequality: *concentrated capital ownership*. While Piketty, like Marx before him, recognizes this fundamental flaw of private markets—devoting an entire chapter to the inequality of capital ownership—he never suggests how to tackle the problem head on. He stumbles across a solution, saying, “…if capital ownership were equally distributed and each worker received an equal share of profits in addition to his or her wages, virtually no one would be interested in the division of earnings between profits and wages.” This ignores the obvious solution of designing policy to broaden capital ownership.

There are multiple reasons why broad capital ownership is crucial to sustainable capitalism. First, as explained above, owners of capital are residual claimants on production, while labor is an input cost. Since capitalist economic logic reduces input costs in order to increase residual claims (profits), one would desire to be on the profitable side of capitalist accounting. This would be the most direct and neutral means to reducing inequality driven by the divergence of capital and labor incomes.

Second, if we want to broadly distribute the returns to capital we need to distribute and manage the *risks* of capitalist enterprise concomitant with equity ownership. Successful capitalism is synonymous with successful risk-taking and we all need a piece of the action. This seems counterintuitive to the objection that poor people and workers cannot afford to assume equity risks. I would argue they cannot afford *not to* and policy should empower them to assume and pool these risks. Broad capital accumulation would not only alleviate inequality, it would enable us to better manage the individual risks of uncertainty by creating the basis for self-insurance through savings as part of the diversification of financial assets and income. There’s nothing like a generous stock of capital (savings) to manage the contingencies (risks) of misfortune.

On a national policy level, broad capital ownership can mitigate the tension between efficiency and equity, growth and sustainability. Policy in recent decades has been driven by the imperative of economic growth and efficiency. This is why policymakers across the world have turned away from equity and economic justice in favor of financialization, debt leverage, and cheap credit to reinvigorate stalled economies. (Political ideologues of both left and right have collaborated willingly in this effort.) In so doing we have sacrificed both equity and sustainability without gaining much long-term stability.

Lastly, on a philosophical and psychological level, I would contend that direct participation as residual beneficiaries of capitalism’s success empowers the individual citizen’s sense of self-determination and human dignity. Remuneration in proportion to equity participation in the economic enterprise of capitalism is the basis of free democratic societies and the foundation of all individual contributions to the community. We should employ the word “equity” purposefully
to include its multiple meanings across the spheres of justice, politics, economics, and social equality.

There are many policy choices to promote capital accumulation and ownership. Some of the more obvious: eliminate capital taxes at the lowest income levels; reward or subsidize savings (under financial repression we have penalized savings to the point where the real return is negative); expand tax-deferred savings accounts for education, healthcare, retirement, and first home purchases (eliminate all other mortgage deductions); consider progressive wealth taxes such as the property tax; revise tax policies that favor debt leverage over equity finance; promote compensation that rewards equity participation in wage contracts (this would require more independent corporate boards to include representation for labor as a block of shareholder interests); insure competitive risk management markets and industries, such as fund management and insurance markets. My personal favorite is to reform the estate tax code to encourage the wide distribution of capital voluntarily before or at death. For the publicly spirited, a private-public program of baby bonds or wealth endowments may do more to dignify the poor over time than charitable foundations.

All these strategies deserve serious consideration by any policy elites who speak to the issue of inequality. Even so, such policies to balance the distribution of capital ownership will be insufficient to manage the natural power law distribution of success which characterizes winner-take-all markets. These effects have been multiplied by information technologies and globalization. Piketty unwisely dismisses Pareto’s insights into power law distributions, largely on the basis that the distribution is not necessarily stable. The more important point is that such power law distributions are ubiquitous in nature and markets, suggesting a deeper truth with which we must contend. I assume Piketty is blinded by his desire to make a stronger case for tax and redistribution, defeatist as it is.

The persistence of skewed distributions in economic markets leads me to prioritize several policy objectives to counter capital concentration: one, empower the poor to accumulate productive capital in pooled asset management vehicles; second, promote capital incomes to supplement labor incomes among the middle class; three, revise housing policies and property taxes to increase supply, unlock the housing market, and allow the pricing of homes to return to cash flow fundamentals; four, insure competitive and transparent financial markets (and Federal Reserve policy) to end financial repression and the cycle of political and corporate cronyism; five, reform the estate tax code to encourage the wide distribution of capital voluntarily before or at death.

A simple explanation of a power law is when 20% of the population owns 80% of the wealth. An excellent exposition of the winner-take-all phenomena of modern markets can be found in The Winner Take All Society, by Robert Frank and Philip Cook. Written in 1995, the 20 years since have confirmed much of the original analysis of unequal outcomes.

We should not underestimate the damage done to the market economy due to the deliberate distortion of the term structure of interest rates. In the modern age of managed economies, manipulating the interest rate by the central bank is seen as an important tool of economic policy. However, the interest rate is the most important price signal in the economy that tells us when to save, lend, and produce, or when to borrow and consume. Rendering that signal inaccurate leads to system-wide misallocations of resources and unproductive behavior, hampering the market’s natural ability to correct and return to a stable growth trend. One wonders how much this explains our current dismal recovery from the 2008 crisis.
and five, reform the estate tax to deal with the massive transfer of wealth to the top 1% of the population that has occurred over the past thirty years of a cheap credit bubble. (One might view this as synonymous with Piketty’s global wealth tax, but in my preferred formulation the estate tax would never be collected. Instead it would merely provide strong incentives to redistribute capital wealth voluntarily, much in the way tax rules for charitable donations do so today. Why empower charitable institutions to do what people could do if they had the means?)

In toto, Thomas Piketty has performed an important service by making us examine the logical underpinnings of our society and its adaptation to change. His big picture approach is invaluable as a study of history as well as providing important insights for economics and sociology. In short, he has identified a crucial challenge market societies face and laid out one possible scenario that should capture our attention. However, I believe he errs in his policy prescriptions and projections for the future. Nevertheless, I endorse his general objective that a broader understanding of capitalism is crucial to defending that which makes for a humanistic society based on the values of liberty and justice. We will continue to perfect the capitalist economic model one way or another because we simply have no alternative – no other system of economic and social organization is as congruent with human nature with its desire for liberty. Contrary to Piketty’s fears, market capitalism—properly understood and judiciously tethered to humanistic objectives—does not condemn us to a future devoured by the past. Rather it promotes the promise of a future built upon those towering humanist legacies of the past.