real-world economics review, issue no. 69
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Piketty vs. the classical economic reformers

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Thomas Piketty has done a great service in collating the data of many countries to quantify the ebb and flow of their distribution of wealth and income. For hundreds of pages and tables, his measurements confirm what most people sense without needing statistical proof. Across the globe, the top 1% have increased their share of wealth and income to the steepest extreme since the Gilded Age of the late 19th and early 20th century.

The Federal Reserve's 2013 *Survey of Consumer Finances* shows that economic polarization has accelerated since the 2008 crash. The 0.1% of Americans have pulled even further ahead of the rest of the 1%, who in turn have widened their gains over the remainder of the 10%. At the bottom of the pyramid, the poorest 10% have faired even worse than the next lowest. The economy is operating like a centrifuge separating rich from poor. But neither Piketty nor the Fed makes an attempt to explain the dynamics causing this polarization. They merely measure its broad parameters.

Some reviewers have labeled Piketty's statistics and policy proposals as Marxist, partly because the title of his book – *Capital in the Twenty-First Century* – suggests that it might aim at updating of Marx's *Capital*.[1] Even Martin Wolf writes of Piketty's book that, "in its scale and sweep it brings us back to the founders of political economy."[2] But apart from seeing inequality as a social threat, there is little similarity either in Piketty's analysis or in his proposed policy remedies.

Marx followed in the classical tradition of Francois Quesnay, Adam Smith, David Ricardo and John Stuart Mill in defining economic rent (including natural resource rent and monopoly rent from legal privileges or control of access point to key infrastructure monopolies) as the excess of price over intrinsic labor-cost value. Volumes II and III of Marx's *Capital* extend value theory to the exploitation of industrial wage labor by capitalists. Using the labor theory of value to define extractive rentier or capitalist exploitation is what distinguishes classical political economy from the post-classical reaction against Marx and other reformers and critics gaining political influence by the turn of the 20th century.

The statistical sources used by Piketty reflect this reaction against treating *rentier* income as unearned. Post-classical theory insists that all income is earned productively, with no source of gain less productive than any other. Making money by privatizing public monopolies and cutting services, or simply price gouging to cover higher costs of interest and dividends, management fees, higher executive salaries and stock options is treated as economically productive as building new factories and hiring employees.

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[1] See for instance Steven Erlanger, "Taking on Adam Smith (and Karl Marx)," *The New York Times*, April 20, 2014.
[2] Martin Wolf, "Inequality time," *Financial Times*, April 19, 2014.

Limiting Piketty's reform proposals to what anti-reform statistics reveal

Piketty sought to explain the ebb and flow of polarization by suggesting a basic mathematical law: when wealth is unequally distributed and returns to capital (interest, dividends and capital gains) exceed the rise in overall income (as measured by GDP), economies polarize in favor of capital owners. Unlike the classical economists, he does not focus on *rentier* gains by real estate owners, their bankers, corporate raiders and financiers, privatizers and other rent seekers.

Piketty is limited by the available statistical sources, because any accounting format reflects the economic theory that defines its categories. Neither the National Income and Product Accounts (NIPA) nor the Internal Revenue Service's *Statistics on Income* in the United States define the specific form that the wealth buildup takes. Most textbook models focus on tangible investment in means of production (plant and equipment, research and development). But industrial profits on such investment have fallen relative to more passive gains from asset-price inflation (rising debt-fueled prices for real estate, stocks and bonds), financial speculation (arbitrage, derivatives trading and credit default insurance), and land rent, natural resource rent (oil and gas, minerals), monopoly rent (including patent rights), and legal privileges topped by the ability of banks to create interest-bearing credit.

A byproduct of this value-free view of wealth is that Piketty suggests an equally value-free remedy for inequality: a global estate tax with a progressive wealth and income tax. Not only is this almost impossible to enforce politically, but a general tax on wealth or income does not discriminate between what is earned "productively" and what is squeezed out by rent extraction or obtained by capital gains.

The advantage of classical economic theory's focus on rent extraction, financialization and debt-leveraged asset-price ("capital") gains is that each form of "unearned" wealth and income has a different set of remedies. But to Piketty's sources – and hence to his analysis – wealth is wealth, income is income, and that is that. He is obliged to make his solution as general as his statistics that define the problem.

Taxing all forms of income or wealth at the same rate does not favor industrial investment over financial engineering. It does not reverse today's fiscal subsidy treating interest as tax-deductible. This tax preference for buying companies on credit – using their earnings to pay interest to bondholders and bankers – enables the 1% to obtain a much higher payout in the form of interest than by dividends on equity financing. The tax collector loses in favor of creditors – and taxes consumers and wage earners to make up the shortfall. Meanwhile, low taxes on capital gains encourage corporate managers to use earnings for stock buybacks to bid up their prices. Piketty's book does not address these tax preferences and distortions favoring the 1%.

Why is inequality increasing? False leads that Piketty avoids, but does not controvert

Piketty shows that inequality is rising, but his broad formula relating overall financial returns (r) to the overall rate of economic growth (g) does not explain how policies have driven the turnaround since 1980. But at least his broad treatment of *rentiers* does not succumb to apologetics based on age and educational levels.

The "life cycle" theory of savings depicts individuals borrowing to consume more when young, and repay out of incomes expected to rise during their working life. They pay interest to "patient" savers who defer their own consumption in order to earn interest. This "abstinence" theory blames debtors for their plight of needing credit to get by in today's world. Inherited wealth seems to play no role, as if everyone starts from the same economic point. Also absent from this "pay later" view is the fact that real wages have stopped rising since 1980. Upward mobility is much more difficult to achieve, and most debtors have to pay by working even harder for lower wages.

It is not by deferring consumption that inheritors obtain their wealth. As Marx put it, it is absurd to view the Rothschilds as growing so rich simply by being Europe's most "abstinent" consumers. And on the macroeconomic level, this individualistic "life-cycle theory" of interest ignores the fact that the economy is an overall system whose volume of debt grows exponentially from one generation to the next as savings accrue and are augmented by new electronic bank credit – extracting interest from debtors.

Another diversionary explanation of wealth disparity is educational status, duly dubbed "human capital" on the logic that each academic step adds to the stream of future earnings. The idea is that better-educated individuals at the best schools earn more – justifying student debt. One CEO of a Fortune 500 company has assured me that the reason he is so rich is because he is so smart and well educated. Other corporate executives tell me that the reason they hire economics PhDs is that it shows that the prospective employee is willing to work hard for a goal to get a better job. The tacit message is that such PhDs have learned to accept writing economic fictions to get ahead. But all you really need is greed, and that can't be taught in school.

On the negative side of the relationship between education and net worth, schooling has become so expensive and debt leveraged that the burden of student loans is keeping recent graduates living at home with their parents instead of being able to start families in homes of their own. For-profit technical schools such as the University of Phoenix have notoriously low graduation rates, but use government-guaranteed loans to create an artificial market selling dreams that end in jobless student-loan peonage taking its place alongside debt serfdom for homebuyers paying mortgages.

Matters are even worse than Piketty's measure of inequality shows. He refers to gross income, not the net earnings *after* meeting basic expenses. To make wages conceptually symmetrical with profits or rents – corporate profits or cash flow *after* meeting the costs of production – the appropriate measure would be wages after meeting basic living expenses. That is why net worth measures are more important than income.

What U.S. official statistics call "disposable income" – paychecks *after* taxes and FICA withholding – is not all that disposable. Recipients must pay their monthly "nut": debt service on bank loans and credit cards, home mortgages or rent, pension fund and health insurance contributions, and other basic expenses needed simply to break even, such as food and transportation to and from work. Faced with these monthly obligations, a rising proportion of the labor force finds itself with scant savings. Hence the "traumatized worker" effect, "one paycheck away from homelessness," too fearful to strike or even to complain about working conditions or the lack of wage increases.

The upshot is that most wealth takes the form of what classical economists characterized as unearned income, mainly from the FIRE (finance, insurance and real estate) sector: interest and various forms of economic rent, inherited wealth and “capital” gains, not to speak of tax avoidance, stock options and other favoritism for *rentiers*.

Piketty’s statistics show a number of turning points in the share of wages compared to returns to capital (interest, dividends and capital gains). The Gilded Age was followed by a move toward greater equality during 1914–50. A progressive U.S. income tax was legislated in 1913, taxing capital gains as normal income – at a high rate. (Only about 1 percent of Americans initially had to file tax returns.) The Great War was followed by the financial crash of 1929, the Great Depression and World War II that destroyed capital or taxed it more heavily. A period of relative stability followed in the 1960s and 70s as progressive taxes and public regulation were maintained.

The 1980 turning point in wealth and income distribution

The great turning point occurred in 1980 after the victory of Margaret Thatcher’s Conservatives in Britain and Ronald Reagan in the United States. Progressive taxes were rolled back, public enterprises were privatized and debts soared – owed mainly to the wealthy. Interest rates have been driven down to historic lows – and after the crash of 2008 the aim of Quantitative Easing has been to re-inflate asset prices by reviving a Bubble Economy aiming mainly at “capital” gains for wealth-holders. These trends have led wealth to soar and become concentrated in the hands of the top 1% and other wealthy families, first during the post-1980 bubble and even more during its post-2008 collapse.

1. Interest rates and easier credit terms promoting debt leveraging (pyramiding)

Interest rates determine the rate at which a given flow of income, interest or dividends is capitalized into mortgage loans, bond or stock prices. Rising steadily from 1951, loans by U.S. banks to prime corporate customers reached a peak of 20 percent by yearend 1979. At that rate it was nearly impossible to make a profit or capital gain by borrowing to buy housing, commercial real estate, stocks or bonds.

Then, for more than thirty years, interest rates plunged to all-time lows. This decline led bankers and bondholders to lend more and more against income-yielding properties. As mortgage interest rates fell, larger bank loans could be afforded out of existing income and rent, because a property is worth whatever a bank will lend against it. This “creates wealth” by purely financial means – an explosion of bank credit financing capital gains over and above current income. Prices for bonds enjoyed the greatest bull market in history.

In addition to lowering interest rates, banks stretched out the maturities and also required lower down payments to attract more customers hoping to get rich by going deeper into debt. And until 2008, real estate – the economy’s largest asset – rose almost steadily. But a byproduct of debt leveraging is that mortgage holders receive a rising proportion of the rental income of property. Home ownership was becoming a road to debt peonage, as owners’ equity declined as a share of the property’s price.

Much the same phenomenon was occurring in industry after 1980. Innovations in leveraged buyouts enabled corporate raiders, management teams and ambitious financial empire-

builders to buy companies on credit, paying earnings to bondholders instead of reinvesting in the business (or paying income taxes). Capital gains were achieved by bidding up stock prices by share buybacks and higher dividend payouts, while cutting costs by downsizing and scaling back pension plans.

Most money is not being made by tangible capital investment but financially. Stock buybacks are being financed even with borrowed funds – going into debt to create short-term capital gains for managers whose pay is tied to stock options. "In 2012, the 500 highest paid US executives made on average $30.3 [million] each … More than 80 per cent of it came in the form of stock options or stock awards. Their incentives are skewed towards extracting value from the companies they run, rather than creating future value."[3]

Gains by the 1% of this sort are not an inherently natural law. "Greed will always be with us. Dumb laws are optional," the *Financial Times* writer just quoted observes. This perception is missing in Piketty's analysis. Thinking about inequality simply in terms of comparing the return to capital to overall economic growth leaves little room for public policy. And in the absence of government taking the lead, planning shifts to Wall Street and other financial centers. The result is as centrally planned an economy as Hayek warned against in *The Road to Serfdom*. But it is planned financially, for purely pecuniary gain, not for economic growth or industrial capital formation as such.

This means that in order to preserve its momentum, financialization evolves into Bubble Economies, requiring ever larger injections of credit to bid up asset prices by enough to cover the interest charges falling due. Wealth-holders can gain only as long as asset prices grow as exponentially as the compounding of interest. This requires that banks continue to lend, or that governments bail out financial markets, *e.g.* by the Federal Reserve's Quantitative Easing or Mario Draghi's "Whatever it takes" at the European Central Bank.

Bankers promote fiscal policies to encourage debt leveraging by focusing the public's attention on personal gains to be made by borrowing to buy assets expected to rise in price. What is suppressed is recognition that the wealthiest layer of the economy gets most of the gains while homebuyers, industry and governments go deeper into debt.

2. Privatization and rent seeking

The second major trend concentrating wealth in the hands of the ultra-rich since 1980 has been privatization. Led ideologically by Margaret Thatcher in Britain after 1979 (applauding Chile's "free market" privatization at gunpoint under General Pinochet after 1973), the pretense is that private management is inherently more efficient than public enterprise. Yet in contrast to the public interest in lowering prices – by subsidizing basic services to make economies more competitive – the aim of private owners is to install tollbooths to extract economic rent.

Under the neoliberal Pinochet-Thatcher style privatizations, capital investments in transportation, power, communications and other basic commanding heights were sold off, mainly on credit. This was the opposite of reform policy a century ago socializing pensions and health care, water, roads and other essential services. Key infrastructure was to be kept in the public domain or (in the case of heavy industry such as British steel) nationalized. But

[3] Edward Luce, "The short-sighted US buyback boom," *Financial Times*, September 22, 2014.

since 1980 infrastructure has been privatized into "tollbooth" opportunities to extract financial returns (interest and capital gains) and monopoly rent.

The richest individuals in the former Soviet Union and many Third World countries have gained their wealth by insider dealings to obtain such *rentier* privileges. In Mexico, Carlos Slim's fortune comes from charging high telephone rates increasing the cost of living and of doing business. This is how America's railroad barons became the Gilded Age elite, the last time that wealth inequality was as high as it is today. The U.S. stock market was largely a market in shares for railroads, much as stock markets in other countries dealt mainly in canals and commercial monopolies or trusts.

This concentration of wealth was achieved by rent extraction, bribery and fraud, facilitated by ideological patter that claims any way of transferring property into private ownership would help society grow richer faster. Piketty's point is simply that having been appropriated, such wealth takes a financial form, which should be taxed to rectify matters. He sees no need to reverse privatization, to change today's tax favoritism for *rentiers*, regulate monopoly prices, enact an excess-profit tax or minimum wage laws, full employment policies, debt writedowns and other specific remedies.

3. The tax shift off wealth and capital gains onto wages and consumer spending

An array of tax shifts has favored the wealthy. In addition to rolling back progressive income tax rates, the "small print" gives special exemptions for the FIRE sector (finance, insurance and real estate). Corporate industry and the wealthy are emulating the oil industry's pioneering tactics to declare their profits in offshore tax-avoidance centers. Real estate investors can pretend that their buildings are depreciating so fast that this fictitious book-loss offsets their otherwise declarable rental income. (Homeowners are not allowed to make such a deduction; only absentee owners can do so.)

Permitting interest payments to be tax-deductible subsidizes debt leveraging at the tax collector's expense. Capital gains are not taxed if they are invested to buy yet more property, or bequeathed when the owner dies. The effect is that in addition to receiving the lion's share of tax cuts, the 1% to 10% receive most of the interest and asset-price gains bid up on bank credit.

Governments are obliged to make up the fiscal shortfall resulting from favoring the wealthy by raising sales taxes on consumers and wage earners, *e.g.*, by Europe's value-added tax (VAT). U.S. state and local governments have replaced the property tax (which provided three-quarters of their fiscal revenue a century ago, but now accounts for only one-sixth) with local sales and income taxes that fall mainly on consumers.

Un-taxing *rentier* wealth favors the 1% who hold the 99% increasingly in debt. To make matters worse, taxing labor and industry instead of *rentiers* increases the cost of living and doing business, shrinking the economy and hence employment and wage rates.

4. Financing budget deficits via bondholders instead of government money creation

World War I (like America's Civil War) showed that governments could finance their own spending by "greenbacks" instead of borrowing from bondholders. But the latter wanted to keep government debt financing for themselves – and to keep governments on a short monetary leash as a means of controlling their policies.

At issue is whether economies will depend on credit creation by and for the 1%, or whether governments will self-finance deficits to promote full employment. Opponents of central bank money creation accuse central bank financing of being inherently inflationary, leading almost inexorably to Weimar-era style hyperinflation. The claim is that private bankers provide more responsible funding. But in practice the 1% promote policies that augment their own wealth by inflating asset prices on credit owed mainly to themselves.

Meanwhile, blocking government self-financing is *de*flationary. By running a budget surplus in the late 1990s, the Clinton administration obliged the U.S. economy to rely on commercial banks for its increased money supply. The result was a sharp rise in the debt overhead (at rising interest rates). Likewise in today's Eurozone, the European Central Bank's refusal to finance government deficits – and limiting budget deficits to only 3% of GDP – is turning the continent into a dead zone.

In contrast to public spending to promote growth and employment for the economy at large, bank credit "creates wealth" mainly by lending against property and financial securities and thus inflating asset prices, not by funding new tangible capital investment. This underlying contrast is a major factor explaining why the 1% advocates policies that increase the market valuation of its wealth vis-à-vis labor's wages. Any reform policy to reverse today's economic polarization needs to address this monetary and fiscal contrast.

5. Debt deflation

The main long-term dynamic holding back recovery in Europe and North America is the debt overhead – a flow of interest upward to bank bondholders and other creditors and "savers." The economy has become a debt pyramid diverting rent and profits as well as wages to pay debt service. Like corporate profits, a rising bite out of wages is being paid out as debt service, especially as wages have merely moved sideways since the late 1970s. Wages hitherto spent on consumer goods are paid to creditors, shrinking markets in the "real" non-*rentier* economy.

Despite his criticism of the financial sector, Piketty does not address the debt, credit or monetary dimensions of economic polarization. He proposes simply to tax the financialized economy that this debt pyramid has created, leaving in place the debt corner into which the 1% have painted the economy. It is difficult to see how a progressive income and estate tax alone can reverse the trend toward polarization without writing down today's debt overhead.

A major reason why the 1% have increased their gains since 2008 is that the Treasury and Federal Reserve bailed out banks, their bondholders and uninsured large depositors instead of obliging them to absorb the loss from having lent much more than borrowers were able to pay. These bailouts, and the Federal Reserve's subsequent Quantitative Easing to re-inflate real estate and other asset prices, were the only occasions on which banks have applauded government money creation – when it is to pay *them*, not to spur tangible investment and employment in the non-*rentier* economy.

These government policies are not the result of an inherent mathematical law about the return to capital vis-à-vis that of the non-*rentier* economy – GDP and wages. Reversing the widening inequality between finance capital and wage labor entails going far beyond Piketty's advocacy of more progressive income and wealth taxation. While certainly desirable, these taxes by themselves would leave in place the political, financial and privatized rent-extracting

structures that serve the 1% to support their debt claims and tollbooth charges on the economy at large.

Piketty's narrow solution reflects the limited scope of his analysis. The 2008 crisis offered an opportunity much like wartime and the Great Depression to wipe out the financial buildup. But the response was to prevent financial losses by bankers and bondholders. Instead of governments acting to restore prosperity, they imposed austerity to squeeze out enough revenue to save banks from insolvency.

Piketty does not call for reversing the debt leveraging that has inflated asset prices, much less writing down the debts that hold the 99% in financial bondage. He accepts the status quo but would tax inherited wealth and restore an 80 percent tax rate such as typified the 1940s and '50s on incomes above $500,000 or $1 million, as if the wealthy will not circumvent such policies by the stratagems put in place in recent decades.

Ideological support for the 1%'s conquest of the 99%

Despite Piketty's focus on today's financial *rentiers* instead of landlords as the major idle rich class, he does not see that sustaining its dominance over the rest of the economy involves the political sphere. He accepts the political and legal environment for granted. His limited vision is what attracts a New York fund manager writing in the *Wall Street Journal*: "Thomas Piketty likes capitalism because it efficiently allocates resources. But he does not like how it allocates income."[4] As if the two can be separated!

The economy is polarizing because of how the 1% use their wealth. If they invested their fortunes productively as "job creators" – as mainstream textbooks describe them as doing – there would be some logic in today's tax favoritism and financial bailouts. *Rentier* elites would be doing what governments are supposed to do. Instead, today's financial oligarchy lends out its savings to indebt the economy at large, and uses its gains to buy control of government to extract more special privileges, tax favoritism and rent-extraction opportunities by political campaign financing in the United States (unlimited since the Supreme Court's Citizens United ruling) and by lobbying.

Politics and the legal system have become part of the market in the sense of being up for sale. As in consumer advertising, ideological engineering is used to "manufacture consent," using the mass media to broadcast an anti-tax and anti-regulatory ethic. Thorstein Veblen described the tactic a century ago in *Higher Learning in America* (1904). Business schools have been endowed, economic prizes awarded and public relations "think tanks" staffed with credentialed spokesmen to shape popular perceptions to accept widening financial inequality as natural and even desirable.

Piketty's statistics show that inequality of wealth and income distribution is higher in the United States than in Europe, but he does not explain that this is largely because public spending and subsidies to promote employment and living conditions are much stronger outside of the United States. His proposed tax remedy does not include structural reforms, much less a public option for banking and de-privatization of the infrastructure still being sold to rent-extractors on credit.

[4] Daniel Shuchman, "Thomas Piketty Revives Marx for the 21st Century," *Wall Street Journal*, April 22, 2014.

Focusing mainly on the exponential accrual of inherited wealth, Piketty rightly warns of a lapse of economic democracy back into "patrimonial capitalism," a *rentier* economy controlled by hereditary dynasties. The world is seeing a retrogression of economic democracy back into *rentier* oligarchy. This prospect makes it all the more important to understand the dynamics that are endowing such dynasties. But Piketty's formula about the rate of return on capital (*r*) exceeding the rate of economic growth (*g*) does not explain how this political maneuvering over public policy affects this ratio. His statistics on inequality in themselves say nothing about the tactics of class warfare to prevent the minimum wage from being raised in the United States, or to impose austerity rather than full employment policies.

As Adam Smith pointed out, the rate of profit is often highest in countries going fastest to ruin. If there are internal contradictions, what may bring the rate of return (Piketty's *r*, increasingly based on debt service and asset-price inflation) back in line with the ability to pay out of growth (Piketty's *g*)? Would his proposed global tax on wealth and high incomes be sufficient to reverse today's widening inequality without changing the fiscal and social-economic structures that the financial oligarchy has created to prevent such a reversal?

It was by dealing with these structures to free industrial capitalism from the vestiges of feudalism that the classical economists were revolutionary, above all by taxing absentee-owned land. So radical was this drive to subordinate the growth of *rentier* wealth to serve society at large that despite almost winning by the early 20th century, it faltered. Marx extended this post-feudal revolution to the industrial economy in a way that reflected the interest of the working majority. But progress along these lines is now in danger of being rolled back under pressure of financial austerity.

When it comes to proposing an alternative, Piketty is no such radical. His version of a singular tax solution – a heavy estate tax and a global tax on the higher wealth and income brackets – does not follow the classical reformers' key distinction between *rentier* "free lunch" income and wealth earned productively. It does not counter the financialization of industry, reverse privatization carve-outs from the public domain, or see a need for a public option to finance budget deficits and retail banking. In that respect his remedy is in line with the post-classical "value-free" reaction denying that any forms of income are unearned and outright predatory.

Piketty's book provides a comprehensive description of the symptoms of pro-*rentier* policy as measured by the inequality of overall wealth and income distribution. But without analyzing or diagnosing the array of strategies by which *rentier* wealth has rolled back earlier policies toward greater economic equality of after-tax income and wealth, it cannot prescribe a remedy to stop today's economic polarization at its taproot.

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SUGGESTED CITATION:
Michael Hudson, "Piketty vs. the classical economic reformers", *real-world economics review*, issue no. 69, 7 Oct 2014, pp. 122-130,

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