

The Problem With Piketty

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Thomas Sowell coined a marvelous phrase to describe the well-intentioned social engineers who always know what needs to be done to improve the wellbeing of the downtrodden. He called them “the anointed” and explained how their reasoning always evolves in the same three stages:

- 1) They identify a problem, which may or may not exist. But whether it is real or not, they always insist the problem is caused by market failures.
- 2) They propose a solution, which inevitably involves a greater role for the State—and for themselves as its high priests (high priests do not work, except within the Temple).
- 3) When their solution fails (as it invariably does), they don’t re-examine their thinking, but just complain that it has been implemented with insufficient vigor. Needless to say, they put forward a new and improved plan they insist will work better next time...

François Hollande put Piketty’s ideas into action—with predictable results

Thomas Piketty is one of France’s great (self-)anointed. Like the rest of his cohort, he eagerly supported François Hollande in the run-up to the 2012 presidential election. Once voted in, the great man started to follow Piketty’s advice, and massively raised taxes on capital. Naturally the policy failed miserably, so Piketty has published a book which explains—predictably—that his recommendations only failed because they were not applied on a worldwide basis. Apparently this book has now become a best seller.

The extraordinary thing is that Piketty’s analysis is based on a massive logical error. His thesis runs as follows: if R is the rate of return on invested capital and if G is the growth rate of the economy, since $R > G$, profits will grow faster than GDP, and the rich will get richer and the poor poorer. This is GIGO (garbage in, garbage out) at its most egregious. **Piketty confuses the return on invested capital, or ROIC, with the growth rate of corporate profits, a mistake so basic it is scarcely believable.**

Bread and butter lesson on ROIC and profit growth from a French bakery

Let me explain with an example. I happen to be a shareholder in an industrial bakery in the south west of France. It has a return on invested capital of 20%, but we cannot reinvest the profits in the company at 20%. If we were to reinvest the profits by putting more capital to work, the profits would not change at all, because nobody in the region is going to buy more bread and productivity gains there are non-existent. In other words, the marginal return of one more unit of capital put to work is zero. So instead of reinvesting in the bakery, we distribute the profits among the shareholders and they invest them elsewhere as they see fit. In short, our bakery has a high ROIC but no profit growth.

At the other extreme, a company expanding rapidly according to a “stack ’em high, sell ’em cheap” model might well show a low ROIC but very fast profit growth. Every company in the world can be “mapped” according to these two criteria: ROIC, and the growth rate of corporate profits.

Over the long term, the growth rate of corporate profits cannot be higher than the growth rate of GDP. That’s simply because if it was, after a while corporate profits would rise to reach 100% of GDP, which we all know is silly. Historically, the ratio of domestic profit to GDP has been a mean-reverting variable (see [On Profits: There Will Be No Revolution](#) and [US Corporate Profits: On The Roof Or In The Stratosphere](#)).

Despite “unavoidable impoverishment”,
two billion have escaped poverty

In reality, all Piketty has done is to rehash the great Marxist theory about the “unavoidable impoverishment” of the working classes, recasting it as a theory in which the capitalist class gets richer and richer over time, and everyone else poorer and poorer. We only need to look at the history of the last 150 years, or of the last 20—in which two billion people have escaped poverty—to see how valid this theory has proved to be.

Still, it was fine for Marx to confuse the ROIC and the growth rate of corporate profits, because he worked in the days before William Jevons, Eugen Böhm-Bawerk, Knut Wicksell, Joseph Schumpeter and Alfred Marshall, who between them developed the notion of the marginal return on one more unit of capital. Alas, one cannot make the same excuse for Piketty, who is writing more than 100 years after this discovery.

The next question, then, is: why has his book become a best seller? The answer was provided a long time ago by the early 20th Century Italian economist Vilfredo Pareto, who argued that to the governing and chattering classes a theory can be:

- 1) true and useful
- 2) false and useful
- 3) true and useless
- 4) false and useless

Why the anointed love “false but useful”
economic theories

Here a “useful” theory is one that increases the power of the anointed, not one that benefits the population at large. Theories that fall into the “false and useful” category are grasped especially fiercely by the anointed precisely because they help them to consolidate their political power. Keynesianism is a prime example.

Which brings us to Schumpeter. In *Capitalism, Socialism and Democracy* he made a fabulous remark which throws more light on the matter. He explained that the rise in living standards allowed by capitalism through the process of creative destruction was going to drive a huge rise in the educational level of the population. The educated but uncompetitive would grow to hate the capitalist system, under which their merits were not recognized, and would try to seize control of educational and cultural institutions in order to teach the youth that markets do not work.

Much the same idea was expressed by the Italian Marxist Antonio Gramsci. If these fellows were to take control of the cultural and

educational world, then 30 years later the political system would fall into their hands like a ripe fruit. Then they would be able to use the democratic process to destroy the free market, having first brain-washed the electorate.

How much are intellectuals worth in a free market?

Don't get me wrong, I am absolutely in favor of education. But I am against a centralized educational system, easily controlled by the anointed.

This leaves open a question: why do intellectuals hate free markets? Because, as French sociologist Raymond Boudon explained, **in a free market they would be paid at their real value.**

Their success in controlling not ideas, which are uncontrollable, but the teaching of ideas, continued Schumpeter, would inevitably lead to a shift from a democratic, market-based system, to tyranny and poverty.

This is exactly what is happening in the old world today. An over-educated, self-anointed elite is fighting tooth and nail to defy market forces and preserve its position in the educational and cultural system. Piketty, as one of this elite, is being feted accordingly. Nothing new there.