Review: Thomas Piketty – 'Capital in the twenty-first century'

Mick Brooks, July 01, 2014

Piketty's book gives the appearance of a monumental work, surveying the development of capitalism over centuries. Marshalling extensive data he shows a disturbing growth of inequality in wealth and income in modern capitalism. Piketty outlines what he calls "the central contradiction of capitalism":

"The overall conclusion of this study is that a market economy based on private property, if left to itself…contains powerful forces of divergence, which are potentially threatening to democratic societies and to the values of social justice on which they are based" (p. 571).

He concludes that there has been a huge increase in inequality under capitalism since the Second World War, and this is likely to deepen in the future. This inequality is fundamentally patrimonial (i.e. parasitic), based on inheritance, not on merit however defined.

Piketty traces a 'U' shaped curve in which inequality in wealth ownership fell quite dramatically from 1914 to 1945. Two World Wars and the Great Depression (1929-33) destroyed enormous quantities of wealth. After capitalism had shaken off these shocks it resumed its 'natural' tendency for rising inequality that seems built in to the system.

In particular he sees inequality rising to the levels observed in the novels of Balzac and Austen in the future. He asks (p. 375) whether the 21st century will be even more unequal than the 19th.

His findings were very unwelcome to establishment economists and other apologists for capitalism. Piketty's book has become hugely controversial, but most of its critics are indeed, to quote Marx, the "hired prize-fighters" of capital.

Piketty as neoclassical economist

His book has been compared to Marx's masterpiece, presumably on account of its title. In fact Piketty shows a lamentable ignorance of Marx's thought. He declares that Marx "totally neglected the possibility of durable technological progress and steadily increasing productivity" (p. 10).

As even a cursory reading of the '*Communist Manifesto*' establishes, Marx regarded the development of the productive forces and of the productivity of labour as the mainspring of historical development.

The main weakness of Piketty's book is that he is working with concepts from neoclassical economics. The purpose of this review is to show how Marxist analysis provides the foundation for a much better explanation of economic phenomena.

Capital and wealth

The first fundamental mistake Piketty makes is that he conflates wealth and capital:

"To simplify the text, I use the words 'capital' and 'wealth' interchangeably" (p. 47).

For Marxists wealth is an accumulation of use values. These accumulated use values may or may not serve as capital. Ownership of capital means owning the means of production. This enables the capitalist class to tap in to the unpaid labour of the working class.

We'll use Jim Ratcliffe as an example. (In the *Sunday Times Rich List 2014* he is the 26th wealthiest person in Britain, said to be 'worth' £3.2bn.) He is a major shareholder in Ineos, which runs the refinery and chemical plant in Grangemouth, Scotland. The workers at the Grangemouth plant produce surplus value for the likes of Ratcliffe. His shares in the company are capital, and his share dividends part of that surplus value. Ratcliffe also owns a yacht, which apparently cost more than £100m. This is definitely wealth. It is not capital. It does not entitle him to appropriate other people's unpaid labour. On the contrary the yacht was bought from surplus value appropriated elsewhere.

Piketty would in effect lump together the yacht and the Grangemouth plant as wealth. A central concept in his book is the rate of return on capital. He derives this by dividing the actual returns to the wealthy (unearned income) by his denominator, which is wealth. By mixing up capital and wealth his rate of return on capital is really no such thing.

Piketty finds that approximately half of all capital stock is residential capital and half professional capital (p.51). He excludes consumer durables such as cars and fridges from his definition, but includes valuables, such as jewellery. Let us assume for now that all the professional capital really is capital in Marx's sense.

Are houses capital?

Piketty knows very well that the vast majority of the population own very little wealth. For those that do, their main form of wealth is their house. This is not capital for the simple reason that they live in it. So half of what Piketty defines as capital is not capital at all. Only those who buy houses in order to live off the rents can regard their housing wealth as capital.

Piketty is misled partly by his acceptance of neoclassical economics. Neoclassical economists float the preposterous notion that people buy 'housing services' so they can rent the dwelling – to themselves (p. 213)! So the house's "value is measured by the equivalent rental value of dwellings", an entirely fictional rent. This is Humpty Dumpty thinking.

The rate of return

Piketty goes on to work out a rate of return on 'capital' for different countries at different times. This rate is completely inaccurate since his definition of capital is wrong.

He finds this rate of return to be remarkably stable over the very long term at about 4-5% since the beginning of the nineteenth century. (The British and French economies provide the best long term series of statistics.) Piketty makes no attempt to explain why this should necessarily be the case, but describes 5% as a "plausible" rate of return.

Both the British and French economies were both growing much slower than 4-5% at the beginning of the nineteenth century, and for most of the time since. This return on 'capital' was not the distribution of the fruits of growth but redistribution from poor to rich, from workers to idlers. It represents a steadily increasing share of national income going to the holders of wealth.

The mistake about the nature of capital also vitiates Piketty's analysis when he assumes, in the usual flip neoclassical manner, that savings automatically become investment. Saving is performed by private individuals and firms, as retained earnings. In the real world saving (i.e. not spending) and investment in production are done by different people for different reasons. Savings may or may not be channelled into investment via the banking system. That depends on what the savings are ultimately spent on. Because of his faulty concept of capital, Piketty does not distinguish between an increase in real investment (capital) and the useless piling up of luxury goods such as jewellery (wealth, but not capital) .

Pennies from heaven?

Where does this magical ability for capital (even if it really is capital) to generate a return such as 5% come from, for those who do no useful work year after year and decade after decade? In Piketty's view it derives from the neoclassical notion of the marginal productivity of capital. In orthodox economics every factor of production gets its own 'reward'. The apologetic nature of this theory becomes clear when we come to the marginal productivity of labour. 'You're paid what you're worth', is the lesson we're supposed to draw.

Piketty's apparent belief that money just begets money is reminiscent of earlier misconceptions as to the origins of wealth. Marx ridiculed the mystifications of Dr. Price, who was obsessed by the working of compound interest. Price declared:

"A shilling put out to 6% compound interest at our Saviour's birth would … have increased to a greater sum than the whole solar system could hold, supposing it a sphere equal in diameter to the diameter of Saturn's orbit."

Marx retorted that Price's fantasies outdid all the fantasies of the alchemists. Where can this flow of income conceivably come from apart from the unpaid labour of the working class? Yet in Piketty's schema the share of national income going to profit is fixed by his formulae and completely unrelated to the share going to the working class (i.e. nothing to do with the rate of exploitation). He divides national income into capital income and labour income (p. 45), but the two are not conceived as being in any kind of conflict.

Piketty's fundamental equations

His fundamental formulae (which he admits are accounting identities – true by definition) are:

a = r x B, where a is the share of capital in national income, r is the rate of return on capital and B is the capital/income ratio (for instance 500% where capital is five times national income in a year).

For Piketty r is broadly equivalent to surplus value in Marx, including both profit on capital plus income from rent and all other forms of unearned income. Apart from defining capital wrongly, Piketty sees the rate of return as a given in this equation, rather than explaining its origin.

The second fundamental equation is that:

B = s/g, where s is the rate of saving and g the rate of economic growth. If saving by the wealthy is increasing faster than growth the capital/income ratio will tend to rise over time.

So Piketty is trying to explain the capital/income ratio but just plucks the rate of return out of the air. Since he equates all wealth with capital, and endows it all with the ability to generate an income for its owners, his definition of saving in the second equation is also erroneous. Spending on yachts and computer numerical control machines are both piling up of wealth ('saving') but only the latter counts as the accumulation of capital.

The Marxist view

For Marx the national output can be resolved into c + v + s, where c is constant capital (money spent on plant and raw materials etc.), v is variable capital (spending on wages) and s is surplus value (rent, interest and profit). To keep it simple we'll assume that c was the result of a past process of exploitation, so that current national income is v + s, the new values produced in a year.

It is quite clear that one of these can only rise at the expense of the other. A rise in wages, other things being equal, will cut into surplus value. That is the objective basis of class struggle, a process Piketty discusses only fleetingly. For him the return on capital is unrelated to labour's share. The wages share is seen as a residual, what's left after capital has helped itself.

For Marx the rate of profit is determined by the formula s/ (c + v), where surplus value is the total profit shared among the capitalist class and constant and variable capital the total costs incurred. So whether the capitalist invests the surplus value back into production or wastes it on luxury items is a vital distinction. In Piketty that distinction is lost.

Expounding the labour theory of value, Marx denies that constant capital can produce new values. It can make labour enormously more productive and so contribute to the production of an ever-increasing mass of use values. That is why, goaded by competition, capitalists tend to invest the greater part of the surplus, rather than spending it on luxuries.

Marx emphasises that capital is a social relation. At the outset he assumes that capital (in the form of buildings, machinery etc.) have values determined by the socially necessary labour time required to produce them. Capitalism has evolved since. Ownership of capital increasingly takes the form of owning shares and even more recondite pieces of paper.

Surplus value is increasingly divided up among different fractions of the capitalist class, all with their property claims. These represent a share in the means of production and entitle the bearer to an unearned income. The precondition for this is that a class exists with no means of making a living – the working class – apart from working for a wage for those who collectively own the means of production – the capitalist class.

Fictitious capital

Piketty uses examples from the novels of Jane Austen and Balzac, both of whom give detailed accounts of the forms wealth and capital took in their times. For both authors the fruits of what can only be the unpaid labour of others dropping relentlessly into rentiers' laps is seen as a natural, god-given process.

The main source of unearned income at the time of Austen and Balzac was from ownership of land or government bonds (lending money to the government to sustain the national debt). Both of these are examples of what Marx called fictitious capital.

Land has a price but not a value. Since it is a monopoly in the hands of the landed interests, they can charge others rent for access to it.

"We have seen that every particular sum of money may be capitalised, that is, considered as the interest on an imaginary capital. For instance, if the average rate of interest is 5%, then an annual ground-rent of £200 may be regarded as interest on a capital of £4,000. Ground-rent so capitalised constitutes the purchase price or value of the land, a category which like the price of labour is *prima facie* irrational, since the earth is not the product of labour and therefore has no value." (*Capital Volume III*, Penguin edition, p.760.)

Owning government securities is a form of money lending. In both cases the 'value' of the title to ownership is determined by the income it will bring, rather than the rate of profit being calculated on the capital outlaid. Everything seems topsy turvy.

Piketty also mentions a more profitable venture from the novels he analyses, but one attended by more trouble and inconvenience. In 'Mansfield Park' Sir Thomas has interests in a Caribbean plantation, which he has to attend to from time to time. The plantation produces something – probably sugar. This is the nearest we get to stumbling across the fact that the income of the wealthy derives the surplus extracted from the exploited class at the point of production. Possibly the slaves were also put to some inconvenience by making a fortune for Sir Thomas, but that is of no interest whatsoever to Jane Austen.

Though this information from the novels of the time is interesting, and shows that there were plenty of wealthy parasites in Britain and France at the time, little attention is paid by either author to the industrial revolution which was then in the process of transforming the world.

For Piketty, "All forms of wealth areevaluated in terms of market prices at a given point in time" (p. 149). Then, as now, much of the ownership of capital consists of owning pieces of paper, financial rather than real assets. As is well known the price of shares and other paper titles to ownership fluctuate wildly. As the concept of fictitious capital suggests, there is no objective basis to their valuation. The price of these financial assets is phantasmagorical and subject to speculative delirium. (For more on this, see *Capital Volume III*, Chapter 25, *Credit and fictitious capital.*)

This should be a huge obstacle to Piketty's attempt to work out the capital/income ratio. Although he mentions the problem at several points, he ignores it as an issue in calculating profits in relation to wealth in the very long term, the time scale that interests him in his book. He also shrugs aside the problem of inflation in his analysis. The same goes for bubbles in asset prices, such as the house price bubble in Spain and share prices in Japan briefly referred to on p. 193. These would clearly have major impact on the nominal values of wealth, that he calls capital.

Inequality in incomes

He looks at the inequality in wealth ownership and then turns to incomes. He sees the explosion in supermanagers' salaries since 1980 as a puzzle to be explained.

He tries to apply the neoclassical concept of the marginal productivity of labour to trends in wages, especially the explosion in executive salaries. He sees this as a specifically 'Anglo-Saxon' phenomenon, and finds the concept of marginal productivity doesn't fit:

"The main problem…is quite simply that it fails to explain the diversity of the wage distribution we observe in different countries at different times" (p. 308).

Piketty concludes that, "Top managers by and large have the power to set their own remuneration, in some case without limit and in many cases without any clear relation to their individual productivity" (p. 24). These super-salaries are very often just "pay for luck" (p. 335).

Marginal productivity has nothing to do with it! In effect he is agreeing with Marx that these obscene 'wages of superintendence of labour' are a concealed portion of surplus value.

Conclusions

The final section of the book is the weakest. Piketty comes across as a moderate social democrat, concerned about rising inequality but unprepared to challenge the capitalist system. He proposes a modest global tax on capital, which he immediately labels "a utopian idea. It is hard to imagine the nations of the world agreeing on any such thing anytime soon." (p. 515)

He spells out in detail the way capitalist interests would sabotage such a plan. As long as they remain in charge he believes the world is likely to carry on as he predicts. Piketty does not contemplate any countervailing power, such as the world's working class, challenging these dominant interests.

Why should inequality rise relentlessly? Piketty sees "the central contradiction of capitalism" as growth slowing so that saving is greater than growth (s/g rises in his equation). Automatically this will lead to capital gobbling up more and more of the national income.

Actually this will only be the case if the rate of return on capital remains unchanged. Is there really no limit to its hunger and greed? Won't workers resist as capital's share threaten to consume the entire national income and leave them with nothing?

Capitalism and crisis

As capital piles up won't the rate of return on each unit inevitably fall? This is the foundation of Marx's law of the tendential fall in the rate of profit. As we know Piketty has wrongly defined residential property as capital. It follows that his rate of return on capital will not correspond to the Marxian concept. What if we use the correct Marxian category to analyse movements in the rate of profit over the long term by stripping out financial assets and residential property? This has already been done elsewhere. Though the rate of profit rises and falls over the course of the boom-slump cycle, it also shows a long term tendency to decline over the course of capitalist development.

http://thenextrecession.files.wordpress.com/2014/04/maito-esteban-the-historical-transience-of-capital-the-downward-tren-in-the-rate-of-profit-since-xix-century.pdf

This research confirms the correctness of Marx's analysis. Tellingly, Maito's findings are in a paper on 'The historical transience of capital'. They are discussed by Roberts in the light of the debate on Pikettyy's book:

http://thenextrecession.wordpress.com/2014/04/23/a-world-rate-of-profit-revisited-with-maito-and-piketty/

Piketty, on the other hand, assumes capitalism will go on for ever, however gloomy his perspectives for the future. It may seem unfair to criticise Piketty for aspects of capitalism that he does not set out to deal with in his book, but the picture he portrays of a seemingly inexorable long term trend misses out the chaotic and crisis-ridden nature of the system. He hardly mentions crisis in the 685 pages of his book.

Recurring crises will inevitably shake up the consciousness of working class people and goad them into revolt. Marxism provides a much sounder framework for understanding the workings of capitalism than Piketty.