Thomas Piketty's Flawed Analyses of Public Debt and Executive Compensation

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Thomas Piketty's book *Capital in the Twenty-First Century* (2014) has already earned an extra sizable share of the world's attention and has prompted a disproportionately large outpouring of ink. This ink has been spilled glowingly (Krugman 2014), lukewarmly (Summers 2014), and devastatingly (Jones 2014). Yet despite the many reviews—including my own in *Barron's* (Boudreaux 2014)—much remains to be said about Piketty's attention-grabbing analyses of modern capitalism.

In this article, I highlight two parts of Piketty's book that deserve closer scrutiny but have largely escaped attention. Although my selection of the parts of *Capital in the Twenty-First Century* to scrutinize here is unavoidably idiosyncratic, I hope that my analysis of those parts will nevertheless contribute productively to today's conversation about Thomas Piketty's impact on our understanding of economic inequality.

Piketty on Public Debt

While discussing late-eighteenth- and early-nineteenth-century Britain, Piketty writes that "it is also quite clear that, all things considered, this high level of public debt

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served the interest of the lenders and their descendants quite well, at least when compared with what would happen if the British monarchy had financed its expenditures by making them pay taxes. From the standpoint of people with the means to lend to the government, it is obviously far more advantageous to lend to the state and receive interest on the loan for decades than to pay taxes without compensation" (2014, 130). Wrong. This passage reveals a surprisingly weak grasp of basic public-finance theory.

Piketty reasonably assumes that if government finances its expenditures with taxes, then the rich would pay a disproportionately large share of those taxes. But he unreasonably assumes that debt financing of government expenditures not only allows the rich to escape higher taxes in the future but also simultaneously gives them a lucrative stream of returns that adds to their net wealth. Unfortunately, alas, for the rich (and for everyone else), real wealth cannot be created in this rabbit-from-a-hat manner.

To see why, first understand that the value of real resources transferred initially by the rich to the government is the same with public-debt issuance as it is with taxation. (We readily accept Piketty's assumption that it is the rich who pay the taxes and that, with debt financing, it is the rich who buy the bonds.[1]) If government today gets *x* amount more real resources to use, then the private sector thereby has *x* amount fewer real resources to use. This reality holds true regardless of the method government employs to get these resources. Therefore, during the current period (the period when the loans are made and before interest starts to be paid on the debt), the amounts of *real* resources at the disposal of the rich are reduced by public-debt issuance as much as by taxation.

The difference is that with taxation, unlike with debt financing, the rich receive in the future neither repayment of principal nor interest on that principal. But this difference is less real than it appears to be at first glance, especially given Piketty's assumptions (in his discussion of public debt) that (1) the rich are the taxman's main targets and that (2) families that are currently rich continue to be rich far into the future.

Of course, the government promises to repay all money that it acquires through borrowing but offers no such promise on the money that it acquires through taxation. The value of the prospect of repayment of money loaned to the government seems to mean that the present value of a plutocrat's wealth will be higher if he or she lends *x* amount to the government than if he or she is taxed *x* amount by government. Piketty certainly makes this assumption, and he seems to believe that the present value of the creditor-plutocrat's wealth will be higher by the full size of the public-debt issue.

But we now ask a crucial question that Piketty ignores: Who tomorrow will be taxed so that government can acquire the revenue it needs to pay its bondholders? If we continue with Piketty's own assumption that rich families are the main source

1. We assume also, along with Piketty, that the method of financing—taxation or borrowing—affects neither the amount nor the kinds of spending undertaken by government.

of tax revenues, then the present value of tomorrow's higher taxes must be subtracted today from the value of the assets of the rich in order to determine just how rich the rich are today. This necessary basic adjustment is one that Piketty does not make.

In short, because the bonds held today by the rich must be repaid tomorrow with higher taxes—higher taxes to be paid mostly by the rich—the rich are not made much wealthier by the government debt that they currently own.

This conclusion does not depend on Ricardian equivalence. That is, it does not require today's rich buyers of government bonds to accurately anticipate and fully internalize the burden of the future taxes that they must pay on those bonds and, hence, to be indifferent to whether they are funding government's activities by paying more taxes today or by lending money to government. Even if today's rich buyers of government bonds are utterly unaware that government will tomorrow raise their taxes in order to get the resources needed to pay the interest (and eventually the principal) on those bonds, the fact remains that government must eventually extract more real resources from the private sector in order to meet its debt obligations.[2] Again, if we continue to assume, as Piketty does when discussing public debt, that nearly all taxes will be paid by the rich, then new issues of government bonds do not make the rich richer (except insofar as government spends the resources in ways that enrich the nation at large).

Although this conclusion holds whether Ricardian equivalence describes reality or not, its validity is more easily seen if we assume Ricardian equivalence. It is intriguing, therefore, that Piketty explicitly argues that early-nineteenth-century Britain was a time and place in which Ricardian equivalence did indeed hold[3]—intriguing because Piketty identifies early-nineteenth-century Britain also as a time and place in which the issuance of public debt made the rich richer by saving them from paying higher taxes. (See the passage from *Capital in the Twenty-First Century* quoted earlier.) Yet if rich buyers of government bonds in Britain two hundred years ago truly did anticipate that their own and their heirs' taxes would eventually rise by the full amount required for John Bull to meet his debt obligations, then it is almost impossible for anyone to miss the fact that public-debt issuance does not allow the rich to escape the burden of being taxed to pay for government's expenditures. And, hence, it is also impossible to miss the fact that public debt issued under the conditions assumed by Piketty does not make the rich richer. Yet Piketty nevertheless inexplicably misses this fact.

2. We assume here that government does not reduce its spending to get the resources needed to meet its debt obligations. Piketty also makes this assumption implicitly in his discussion of public debt.

3. Piketty writes that David Ricardo "had intimate knowledge of the British capitalism of his time" (p. 134). Therefore, Ricardo saw—Piketty believes accurately—that the "increase in public debt [to finance Britain's war against Napoleon] seemed to have been financed by an increase in private savings" (p. 134). I note only in passing that Piketty is wrong to suppose that Ricardo believed that Ricardian equivalence held for early-nineteenth-century Britain. See O'Driscoll 1977.

Piketty on the Market for Executive Talent

Another weak part of Piketty's analysis is his explanation of the recent growth of income inequality in the United States. He blames the surge in corporate managers' annual incomes for the bulk of this rising inequality.

According to Piketty, high executive compensation in the United States today has little to do with managers' productivity and almost everything to do with the cozy relationship between managers and corporate boards. Managers and board members are clubby friends scratching each other's well-massaged backs and setting each other's exorbitant salaries. Piketty specifically blames (what he assumes to be) excessively high and wasteful executive pay on lax American "social norms" (p. 332) that cause people to tolerate very high executive salaries, combined with cuts in top income-tax rates. Piketty reasons that because tax cuts mean that executives keep more of what they are paid, tax cuts give managers stronger incentives to lobby corporate boards harder for higher pay. This argument is ironically one of the few instances in which Piketty recognizes that cutting taxes causes people to work harder to raise their incomes!

Mysteriously, Piketty never asks the obvious question: Why do shareholders continue to invest in corporations that so wastefully spend their funds? Here is an even deeper mystery: If current patterns of executive compensation serve no purpose other than to enrich unproductive corporate oligarchs, what explains the high and rising market value of the capital that Piketty believes to be the main driver of increasing wealth inequality? How can it be that the value of capital invested in corporations continues to grow if boards of directors are consistently inattentive to the productivity of their management teams? Piketty does not ask these questions because, for him, wealth perpetuates itself. Wealth grows automatically, for the most part independently of human creativity, risk taking, effort, and entrepreneurial gumption.

In reality, of course, wealth does not grow automatically. It must be carefully, skillfully, *and continually* nurtured. Therefore, if Piketty's peculiar theory of executive compensation were an accurate description of today's reality, corporations' market values would at best have stagnated over the past few decades and capitalist plutocrats would not have reaped the ever-greater wealth that Piketty takes such pains to show that they in fact have reaped. These plutocrats (as well as the masses) would today be far less prosperous than in fact they are. Yet, in fact, over these years the market values of corporations generally did grow quite impressively.

Piketty appears to be untroubled by this inconsistency between his theory of executive compensation and the reality of the great growth in corporations' market values over the past few decades. Nevertheless, had he more carefully examined the empirical literature on executives' compensation, he might have been more reluctant to assert that their pay is unrelated to managerial productivity. As the University of Chicago's Steven Kaplan reported last year in *Foreign Affairs,* when he and Joshua Rauh analyzed seventeen hundred firms, they "found that compensation was highly related to performance: the companies that paid their CEOs the most saw their stocks do the best, and those that paid the least saw their stocks do the worst" (Kaplan 2013).

There is no doubt that contrary data can be cited on the relationship between compensation and productivity. Yet this fact makes it all the more important that a scholar bring sound economic reasoning to the table. A skilled and careful scholar, when confronted with the claim that executive compensation is untethered from executive productivity, would ask questions that Piketty ignores. This skilled scholar would ask, "Why do shareholders continue to invest in corporations?" He or she would also ask, "Why do no profit-hungry, entrepreneurial capitalists try to exploit this market failure by setting up corporations that pay their executives more sensibly and in ways that induce increased productivity? Why do the values of corporate shares continue to grow? Why is the real value of the Dow Jones Industrial Average today about 650 percent higher than it was, say, in 1981—the year before the top marginal personal income-tax rate in the United States was cut from 69 percent to 50 percent?"

Piketty's failure to ask such questions is part of the larger, overarching flaw in his book: it contains far too little microeconomic analysis. And that flaw is fatal.

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