



Episode 462: We Found a Major Flaw in the Egalitarian Argument

Guest: Gene Epstein

WOODS: When we had our meeting in New York, our three-hour marathon conversation, one of the topics that came up was Piketty and his book, and on the show notes page for today – let's see this must be Episode 462 – TomWoods.com/462, I'll link to a couple of episodes that we've devoted to this topic, but you have a different angle on it, and for the sake of completeness, I want your point of view added here as well.

EPSTEIN: Yes.

WOODS: Let's start off with the point that you were making to me that I had read, but I had never put it quite this way, about this book, *Capital in the Twenty-First Century*, being one of the most unread so-called popular books in America today, in the world today.

EPSTEIN: Yes. It's sold over a million copies, and just this week, a sub-sequel, but actually a prequel, which even has come out, called *The Economics of Inequality*, put out by the same publisher. It's been a publishing phenomenon. And indeed, it's called *Capital in the Twenty-First Century*, published last year by Thomas Piketty, and I think you did three outstanding podcasts about it. You brought in your heavy guns, the great and brilliant, our mutual friend, Bob Murphy, to shoot down the thesis involving capital and income.

And I think one of the problems with this book is that it is indeed, as a *Wall Street Journal* article pointed out somewhat facetiously, probably the most unread book, in terms of length, in history. How do they do it? In terms of high tech, they did it, because if you have a Kindle edition of the book, as I did for example, you can easily mark passages that go right to your hard drive and that you can refer to. So apparently, they got research showing that the vast majority of references of passages stopped at page 26 – page 26 in a book that's 700 pages long. And so that pretty much indicated that nobody went further. I actually, like a good libertarian, I read every page of that book, as did Bob Murphy and as did others, but the vast majority of people never finished it.

Now of course, that puts it pretty much in the category with the book it must imitates, which is *Das Kapital*, by Karl Marx. Nobody's read that book either, and virtually

nobody has read the *General Theory* of John Maynard Keynes. But as you and I agreed when we talked about it, Tom, when a book is unread but notorious, and when it sells over a million copies and it's still unread, it's especially dangerous, because anything you want to say about it can be said, because nobody has any special recollection of what was really in the book.

Now, what I discovered was, when I actually read it cover to cover, and in fact we read certain portions of it, is that there is a hoax, a fraud at the core of this book that even a heavy hitter like Bob Murphy missed. And indeed, I ran a long review of the book by a distinguished economist; he missed it as well. And the core problem is — I'm going to begin by just explaining it in terms of an analogy — imagine that Karl Marx had published *Das Kapital* with a passage with several pages, indeed, or even a chapter in the book, which declared that the thesis does not at all apply to British capitalism, that when it comes to British capitalism, it's a different story altogether, that the whole idea of what happens wages and proletariat and all the rest of them doesn't apply to British capitalism. Well, if that had happened, then somebody eventually would have noticed it and wondered how it is possible for Karl Marx to have such an aggressive thesis about capitalism, and yet to find that it doesn't apply to what was at that time his principle *bête noire*, British capitalism.

Well, the same thing has happened with the Piketty book, and I think that, on the one hand, it's kind of funny that those who put in the heavy guns to shoot down this idea that capital accumulation, that capitalists get so much richer than the workers, the wage earners, and that this is potentially terrifying — that's the term that Piketty uses — that it's potentially terrifying, because if capital compounds at 5% growth rate and wages comes at a 3% growth rate, then that 2% margin can compound over years, and that is potentially terrifying.

And so Piketty made that declaration; Bob Murphy shot it down, but in a way even Bob was missing the real problem, the real core issue in this book. And here the best thing I'm going to say for poor Krugman is that he didn't miss it. He recognized what he called the intellectual sleight of hand in Piketty's book. But Krugman being fundamentally dishonest, acknowledged it, but then in further writings went on to forget it as well. But first I'm going to read from Krugman, because he's the perfect set up to what is really in Piketty's book. Krugman wrote in his celebratory review in the *New York Review of Books* about Piketty's book, "And yet, there is one thing that slightly detracts from the achievement. A sort of intellectual sleight of hand, albeit one that doesn't actually involve any deception or malfeasance on Piketty's part. Still, here it is. The main reason there has been a hankering for a book like this is the rise, not just of the 1%, but specifically of the American 1%. Yet that rise, it turns out, has happened for reasons that lie beyond the scope of Piketty's grand thesis."

Now, again, that's Krugman admitting to the intellectual sleight of hand, and indeed, Krugman is absolutely right. If you check Piketty's book, there is a section called "The Rise of Super Salaries." And it reads as follows — begins this way: "Let me now turn to the causes of rising inequality in the United States. The increase is largely the result of an unprecedented increase in wage inequality, and in particular, the emergence of

extremely high remunerations at the summit of the wage hierarchy, particularly among top managers of large firms." That's where it occurred. In other words, Piketty is scrapping his thesis when it comes to the *bête noire*, the United States.

WOODS: All right, let me jump in here, Gene. For the layman, the person who is a complete beginner to this, explain in layman's terms what fundamentally is the Piketty thesis, so they can really see how he's abandoning it here.

EPSTEIN: Piketty's thesis, again, as I said, what is potentially terrifying is that the rate of return on capital exceeds — the rate of return or the rate of growth of capital income, of the capitalists' income, which could be 5% a year, will exceed the rate of growth of income of wage earners and salary earners.

WOODS: Okay, so the thesis then is that capitalists are bound over time, the income gap between them, is bound to increase over time, because the capitalists are going to get a great average return than the laborers. That's all it is.

EPSTEIN: Precisely. As I said, if it's 5% a year for the capitalists' growth rate, and if it's 3% a year for the wage earners and salary earners, that's a 2% gap. And again, I quote from Piketty, that can compound 2% every year, and that gap, again this is his words, is potentially terrifying. It goes on and on and on at 2%. That was the thesis. Now that was the thesis that Bob Murphy, for example, very ably unraveled and shot down. But again, Bob brought in the heavy guns by taking Piketty seriously, but what it turns out to be is that Piketty does not seem to believe that his very messy and chaotic idea applies to the United States. Now that's I think at its core an amazing intellectual sleight of hand, and in itself, it raises questions about what this book is really all about. But that's I think the five-minute version on why this book at its core is a fraud. Again, it's similar to Karl Marx saying my thesis doesn't at all apply to British capitalism, his *bête noire*.

But let's pursue this whole idea, because Piketty does indeed pursue it. It's not an off-handed reference in his book. It goes on for pages. He goes after CEO salaries, and really, the intellectual level of what he discusses is really I think a cut or two below the sort of stuff you might occasionally read in the popular magazines about how those CEOs are making far too much. But again, it's not something that can be easily overlooked, because Piketty pursues it. Well, let us pursue it for a moment, about the CEO salaries and why he thinks they are such a problem and what has been going on.

Well, first of all, what is potentially terrifying about this? The potentially terrifying idea about capital versus income is, again, the 2% gap, if it goes on for years, it's going to double; in 70 years, I guess 2% is a doubling, so the gap is just going to become similar to the idea of the relative immiseration of the proletariat, similar to Karl Marx's thesis. That's potentially terrifying.

But just for starters, what he spent to the potentially terrifying implications of CEOs, the median CEO tenure has been variously estimated at 6 to 10 years. And so then they usually go on to something else. Their moment in the sun when they're receiving

these, in Piketty's terms, unfairly high salaries, does not go on forever. So we can pretty much lay to rest the idea of this being potentially terrifying. Then somebody else gets the job as CEO, then somebody else after that, and there's nothing potentially terrifying about it.

Now let's take another issue that Piketty raises, which I think at its core is pretty hilarious. He basically says, he trots out the old canard about why these CEOs are paid too much: it's their unholy alliance between the executives and the paymasters. I quote from his book: "At the very highest levels, salaries are set by the executives themselves or by corporate compensation committees, whose members earn incomparable salaries, such as senior executives at other large corporations." I imagine that some of your listeners are familiar with that argument. Your pals serve on the compensation committee, and you serve on their compensation committee, and everybody pays each other way too much, way out of proportion to what the market would pay, and that's why the CEOs have been making so much.

But here's the funny turn in Piketty's analysis: he sometimes does ask a difficult question of himself. Why didn't this abuse occur prior to 1980, when it all started, according to him — when these CEOs' salaries took off. Because he fully acknowledges that there's corruption at the top. The compensation committees consisting of your friends had persisted for years. What happened in 1980 to suddenly turn these CEO salaries into these gargantuan emoluments that hadn't occurred prior to 1980? Well, his answer is the marginal tax rates. Now I quote from him again: "The very large decrease in the top marginal income tax rate after 1980 seems to have totally transformed the way top executive pay is set, since top executives now had much stronger incentives than in the past to seek large raises."

So here's his, in other words, explanation: the top rate of CEOs on income was 70% from 1965 to 1980. And then it started to fall in the 1980s. So according to Piketty, from 1965 to 1980, the CEOs never actually asked their pals to pay them millions of dollars in emoluments, because, after all, they would only retrieve 30 cents on the dollar had they done so. The marginal tax rates were just — providing there was too much of a disincentive to ask for higher salaries. That's Piketty's explanation, his attempt to square the circle and explain why this corruption at the top only started when the marginal tax rates began to fall, and when it then became possible for the CEOs to rescue more money.

WOODS: Now, does the truth of the matter have anything to do with restrictions on corporate takeovers?

EPSTEIN: Well, you know, I don't know. Actually, in terms of the truth of the matter about why — well, I'm sorry, elaborate on your point about corporate takeovers.

WOODS: Well because what I'm thinking is that if there are — I know there is at least one major piece of legislation that makes it more difficult to engage in a corporate takeover. So if you had a situation where salaries were just absolutely outrageous, well one thing you could do in a takeover is completely renegotiate them all and

whatever, but if it's more difficult to engage in this, it's harder to make those adjustments.

EPSTEIN: Yes.

WOODS: And the same people who are upset about CEO salaries also want to stop corporate takeovers.

EPSTEIN: Mm hmm. Well that's an excellent point. The only point I wanted to make about the ludicrousness, in this case, of Piketty's analysis is that he first of all assumes that from 1965 to 1980, the CEOs were not that well paid because of the high marginal tax rates of 70%. One problem with that is that we know that the tax shelters were so abundant that most of them probably never paid 70%. But the ultimately funny part about it is that Piketty becomes the most extreme Lafferite imaginable. The disincentive about the marginal tax rates is that they didn't even want to ask their pals to pay them 30 cents on the dollar. In other words, every extra million they could have earned, they would have netted \$300,000. So why not go for it? It's pretty effortless to have these conspiracies that he conjures up.

So my only point is that his attempt to explain away the idea that if the CEOs cabals and conspiracies were at work, then clearly they would have paid themselves gigundous salaries in the 1960s and 1970s falls apart, because again, they had plenty of incentives at 30 cents on the dollar, and again, this implies that that just little bit of extra marginal tax rate meant that they didn't even want to lift a finger to ask their pals to pay themselves something extra. But you're quite right, Tom, that of course part of it is that restrictions on takeovers makes it easier for companies to pay their CEOs' salaries.

But really the explanation for why CEO salaries began to take off in the 1980s, in terms of market conditions, I'm sure you realize is a fairly easy one. The idea of the cabal is ridiculous. The best article to look at about this appeared in *Foreign Affairs*, by economist, Steven Kaplan of the Chicago Booth Business School, called "The Real Story behind Executive Pay." One of the crucial points he makes that should be the initial killer about why the cabal and conspiracy argument doesn't work is that privately held companies actually pay their executives even more than publicly held do. And the privately held companies, the boards are run by the shareholders, the huge shareholders, who have every desire to pay the CEO not a dollar more than they have to. So that in itself would indicate that it can't be cabal-ous.

As Steven Kaplan also points out, the premium on talent is pretty much ubiquitous. Lawyers at the top law firms are getting gigundous salaries. The hedge fund managers are. Athletes, actors — it's part of, obviously, the large size of these companies, the global reach of these companies, the global reach of movies, the global reach of hedge funds. It's fairly easy to explain the exploding CEO pay in those terms. The rise of free agency and executive search firms also helps explain it. There's no question that these people are pretty much being paid market rates. In addition, there's also no question that there's nothing potentially terrifying about it, in Piketty's

terms, because it's fairly clear that the CEOs have their 5 or 10 years in the sun; they make a gigundous salary for a while, and they pretty much fade out and they're replaced by others.

So at the core of this book, at the core of this entire, 700-page tome that nobody has read, we're looking at old wine in new bottles. We're looking at the usual complaint about how CEOs are getting paid too much, because the boards are their pals; everybody on the compensation committee is their pal. And as you indicate as well, the difficulty of corporate takeovers only tends to exacerbate their salaries. But probably by and large, they would be getting these salaries, just like athletes get incredibly high salaries, movie stars, corporate lawyers. The U.S. economy is operating on a global basis, and it's become very important to get the right talent, and the amount of money involved is relatively small, in terms of the potential returns you get from buying the right talent.

Now, I want to go back to Krugman for a moment, and recognize that Krugman had his moment of honesty, in which he accuses this guy that he's been praising to the skies of intellectual sleight of hand. But Krugman has pretty much relied on the bad memory of everybody and the fact I guess that nobody's read the book to continue to declare that the book is about something else, not at all about CEO salaries.

So here's a quote from a follow-up article that Krugman wrote, called "The Piketty Panic." And Krugman is now declaring, "What's really new about Piketty's *Capital* is the way it demolishes that most cherished of conservative myths, the insistence that we're living in a meritocracy in which great wealth is earned and deserved...But how do you make that defense if the rich derive much of their income not from the work they do but from the assets they own? And what if great wealth comes increasingly not from enterprise but from inheritance?"

Now, this is a part of a talk I delivered, in which I basically said that Piketty's book is about inequality, and it turns out you can spin that book in any way you want. You can make up anything you want about what that book says, and Piketty, who I think at the core is a very confused man, is going to go along with almost anything you say. Krugman originally wrote that it's about capital — and that's what the book is supposed to be about, the capitalists making a lot more than the wage earners, and that's potentially terrifying. And then Krugman admits that there's an intellectual sleight of hand, because it doesn't apply to the U.S. And then a month later, he's writing a piece, called "The Piketty Panic," and lo and behold, the Piketty book is about inherited wealth, that's the core of the book.

And I think that it's time to sort of call a halt, time to recognize the chaos that's ensued, and the fact that in a way, this book is kind of a hydra-headed monster. Let me also read from Joseph Stiglitz, who is another Nobel prize winner, who had his own take on a book he probably barely read at all. I doubt that Stiglitz got to page 26. Stiglitz writes the following: "One stream of the extraordinary discussion set in motion by Thomas Piketty's timely, important book, *Capital in the Twenty-First Century*,"

has settled on the idea that violent extremes of wealth and income are inherent to capitalism."

Well, that's what we thought the book was about: violent extremes of wealth and income. But no, says Stiglitz. This is actually a superficial reading of Mr. Piketty's work, which provides an institutional context for understanding the deepening of inequality over time." Stiglitz goes on to say, "Our current brand of capitalism is an ersatz capitalism. For proof of this go back to our response to the Great Recession, where we socialized losses, even as we privatized gains...If it is not the inexorable laws of economics that have led to America's great divide, what is it? The straightforward answer: our policies and our politics...So corporate welfare increases as we curtail welfare for the poor."

Now, aside from that idea of curtailing welfare for the poor, to our astonishment in this riot of intellectual commentary on a book that nobody has read, Stiglitz is almost sounding like a libertarian. He's inveighing against corporate welfare, against crony capitalism, and indeed, those of us who are libertarians can object to inequalities that result from the force and fraud of crony capitalism. That's Stiglitz's version of the book. And so it's almost become an anything goes, just fill-in-the-blanks kind of book, because anything you want to say about this book, you can say as long as it's sort of a little bit about inequality.

Now, I think that, in terms of calling a halt to this on the part of libertarians, we might begin with economist, Garrett Jones, who proposed the 10th Commandment Club —

WOODS: I was going to ask you about this. Yeah.

EPSTEIN: Yes, absolutely. The point you made, actually last podcast in terms of actually addressing the issue of inequality, is that at its core, the success of Piketty's book is that he's stirring up this disquiet that most people feel about inequality and income, about the fact that some people earn more than others. And I think it's an important issue for libertarians to unravel, important for us in particular for us to say that it's not that we object to inequality as such, but certainly the gross inequality that results from crony capitalism; the force and fraud in crony capitalism, we object to, because we object to the process. But let's start with Garrett Jones' tongue-in-cheek 10th Amendment Club —

WOODS: No, not 10th Amendment Club.

EPSTEIN: 10th Commandment Club.

WOODS: There you go.

EPSTEIN: Thank you. 10th Commandment Club. Jones writes, "We could use tolerance for luck-based inequality, for the inheritor of a fortune, for the pretty good CEO who gets an eight-figure bonus just because his company's product went viral. That's why I

propose the creation of the 10th Commandment Club. The 10th Commandment, 'Thou shalt not covet —' or as he writes, "'You shalt not covet,' is a foundation of social peace." And indeed, of course, another economist added, "The commandment against stealing is a good one as well." But the 10th Commandment Club basically talks about coveting.

And I think this segues into what I would argue — I don't know where you stand on this, Tom — I would argue that the best statement about inequality is in Hayek, Friedrich Hayek's book, the second volume of his series on law and legislation, called *The Mirage of Social Justice*. And I think in that book, he addresses the rather hard-nosed view that I think libertarians must take about inequality. If you give me a moment, I want to read from a couple of key sentences from Hayek on this.

Firstly, in *The Constitution of Liberty*, he makes the first declaration, which I think no libertarian can object to, we have to accept: "Not only has liberty nothing to do with any other sort of equality, but it is even bound to produce inequality in many respects. This is the necessary result and part of the justification of individual liberty: if the result of individual liberty did not demonstrate that some manners of living are more successful than others, much of the case for it would vanish." Now, notice that Hayek used the word "more successful"; he did not use the word "meritocratic," because the word "merit" is anathema to Hayek, as I think it should be by and large to libertarians.

Now, in *The Mirage of Social Justice*, Hayek comments, "The market order does owe its origins to beliefs about merit, nor was it originally justified in this manner." It does not owe its origins to beliefs about what people deserve. Now, what does it owe its origins to? Hayek declares, "The market order could develop when a thousand years of vain efforts to discover substantively just prices or wages were abandoned, and the late schoolman taught instead that the prices are determined by just concepts of the parties in the market, i.e., the competitive prices" — and wages, we might add — "arrived at without fraud, monopoly, and violence was all that justice required." In other words, competitive wages, salaries arrived at without fraud, monopoly, and violence was all that justice required, and that the idea of the just price or the just wage, that's all in vain.

And I think we ought to start by pointing out that Thomas Piketty has probably by rough estimates cornered about \$2 million from the sale of this single book. Probably his speaker fees have gotten him additional sums well into the six figures, and you and I don't think that he merits it, because I think his book is a bag of wind, but we have no right to object. He sold that book — and by the way, nobody has a right to their money back, simply because they couldn't get past page 26. That wasn't part of the deal either. They might feel cheated; they might find that this damn book is unreadable and boring; I can't read further, but they plunked their money down, and that's that.

And furthermore, if Piketty wants to leave that 2 million bucks to his kids, that inherited wealth — of course, that assumes the French tax collector hasn't taken a good portion of it, but I'm sure there'll be a fair amount left if the book continues to

sell, and he's got subsequent book, this new book out, which is probably going to sell because it's got his name on it. We have no right to begrudge him this amount. And those huge sums that put him in the global 1%, or indeed, the global 1/10th of 1%. He does not merit that result, but you and I as libertarians have no right to object.

The only saving grace of the free market is it lifts all boats. It lifts the standards of the broad masses of people. I liked what you said the other day, Tom, in a lecture that was on your podcast, that if libertarians really hated poor people, we would wish socialism on them. And so the only moralistic, the only moral point is that it makes everybody a heck of a lot richer than they otherwise would be, but as for sorting out the merit of whether somebody deserves more than somebody else, I think as long as it's not through force, fraud, or Hayek uses the term monopoly – I would say by and large of course, that's the monopoly of the state – as long as it doesn't operate through an unjust process, then the result is nothing that you and I can object to. And that by and large is a fairly tough-minded thesis that has a little bit difficulty going down among most people, but I think that it's the only position that you and I can take.

WOODS: Well, Gene, I appreciate your analysis of all this, and I want to make sure before we wrap up that you get a moment to tell us about upcoming events that you have in your Junto forum that takes place regularly in Manhattan, and I'll be participating in that in December – we'll get to that – but you have two great events, that, if I were in town, I certainly would attend myself.

EPSTEIN: Well, Tom, you're a great entrepreneur; you've got all these little business going. They should probably be the two Tom Woods tours of the touristy section of Manhattan. The first one would take place in late September, early October, and you can see some shows; you can do a few things, and then you can walk over on the evening of Thursday, October 1st, to 20 W 44th Street, where I'm going to have Michael Huemer, who I think appeared on at least two of your podcasts –

WOODS: Yeah.

EPSTEIN: In any case, Michael Huemer, the brilliant anarchocapitalist philosopher, the author of *The Problem of Political Authority*, is going to debate the guy who calls himself basically a classical liberal. He's a fellow traveler and a great guy, Richard Epstein, is going to debate Michael Huemer about the merits of anarchocapitalism. That's the evening of October 1st. It's going to be an Oxford-style debate, and the audience can ask questions and participate and vote before and after – before on the resolution having to do with anarchocapitalism and government, and then after on the resolution, and whoever moves the needle gets the prize. Richard Epstein actually wrote me graciously that it would be a real tonic to sound like the big government guy for a change. That's what Richard is going to do, because he's going to defend government. Much of the time he knocks government, because he's a minarchist. He believes in the Founding Fathers' edition of government. Michael Huemer goes him one better and believes in anarchocapitalism. So it's going to be a square off between two sharp people.

But then of course, the ultimate event is going to be a debate about Alexander Hamilton. That's December 3rd. If you want to participate in the Tom Woods tour Manhattan event, that's going to be Tom Woods versus Michael Malice. Michael Malice is going to defend the reputation of Alexander Hamilton, and Tom is going to denigrate it, I gather. And that's December 3rd, Thursday. It's 20 W 44th Street. If you know Manhattan, that's just west of 5th Avenue, pretty much in the touristy section of town. There's no charge. The hall seats 200 people, and I recommend that you make both events.

You might even want to see a play on Broadway that's raking it in. Once again, we can't argue with those returns, Tom, even though you would be silently hissing and booing. It's a musical called *Hamilton*, and it's based on the Ron Chernow biography of Hamilton. I gather it has a very amusing — I bought tickets to it, by the way; I'm going to see it before the debate happens — it's got a very amusing rap song debate between Jefferson and Hamilton that enlivens the show, and so you might want to take in that show. And then of course, get your position on Hamilton corrected by listening to Tom Woods debate Michael Malice on December 3rd on that issue.

WOODS: What is the — forgive me if you mentioned this; my short-term memory is terrible these days — what is the website, so people can look at this?

EPSTEIN: The website, well if you just put Junto, it's named by Vic Niederhoffer, the philanthropist who pays for everything, after Ben Franklin's group, which was also called Junto for group, and just put Junto into the website, and you should find it in a bit, and it's perhaps the first entry, perhaps the second into Google, and you'll find it listed. 20 W 44th Street is a pretty easy address to find, just off 5th Avenue. I gather you'll be linking to it on your own website, Tom?

WOODS: Oh yes, absolutely. And I just sent it out to my newsletter list.

EPSTEIN: And I'm going to be the moderator and ask a couple of tough questions in each case of both sides, but the moderator doesn't vote. I'm going to run again the Oxford-style debate in a very orderly fashion. This will be of course an intellectual sprint, not a marathon — marathons are when you actually read the book and make up your mind — but I think the clash of ideas on the issue Hamilton, on the issue of anarchocapitalism is you'll inevitably walk away learning something you didn't quite realize from the side that you might disagree with.

WOODS: Well I'm very much looking forward to it. I'm very glad we were able to work it out. Gene, thanks again for talking to us today. We'll be back in touch with you again soon.

EPSTEIN: Sure. Thanks again.