



### **Episode 318- Piketty Taken Down for Good?**

**Guest: Phil Magness**

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**WOODS:** We've talked about this topic on this show in the past, but it was very theoretical, and what's interesting about this paper as you guys, in fact, have noted in touting and talking about the paper is that here you're focusing on what was supposed to be the strength of Piketty's book. It was supposed to be that whether or not you accepted his theoretical apparatus, you can certainly rely on his robust aggregations of data. Here, certainly he's beyond reproach. And this paper is a relentless dismantling of so much of the sheer, raw data that he's using.

**MAGNESS:** Right. You know, what I actually say is that if you look back to some of the early reviews of Piketty's book when it came out, Tom, he gained quite a bit of a claim from very prominent economists. Paul Krugman weighed in, several other writers on the left, but also people on the right. And the almost uniform theme was, here's a book, it has a little bit of a funny theory behind it. It's kind of unconventional. It's definitely outside of the mainstream of what the academy would say, particularly on tax theory, but nonetheless, he has a lot of data. He's brought all this data to bear that tells a very clear story that inequality is on the rise, and we're on a straight march back to the Gilded Age in some respects.

**WOODS:** And it looks as if what you're showing in this paper is every time he engages in some kind of methodological sleight-of-hand, or he has to make some kind of decision about the use of data, by an interesting happenstance his decision always yields a result that points to the conclusion that he wants.

**MAGNESS:** Yeah.

**WOODS:** Let's get started with what exactly you do here in the paper. You start off with a few historical episodes that you and Bob Murphy freely admit don't necessarily in and of themselves dismantle the whole book, but they get you thinking that you can't just trust this guy's word for things, that you have to look deeper. And the two episodes I want to look at first are the treatment of the New Deal, and particularly tax policy in the '20s, and then into the '30s, and then secondly, the history of the minimum wage from about the '70s up through Barack Obama, where his version of things is so off base that you can hardly imagine where he

got it from. Just the assumption that no one would check? I don't know. But start off with the story that he wants us to take away from the '20s and '30s.

**MAGNESS:** The interesting thing about Piketty is it is fundamentally a historical work. It's an attempt to weave a very specific narrative on how world economic events played out across the 20<sup>th</sup> century, and then he has policy prescriptions out of it. One of his big policy prescriptions, and this is the thing everyone has been talking about, is this global wealth tax. He wants basically a tax applied to income earners above a certain level, of outrageous rates, basically 80% plus an additional confiscation rate that's tacked on top of that. And one of his key historical points is he basically goes back to the New Deal era in the United States and says, well, the Americans could have pioneered this way of thinking. He cites some of the rates that were put in, the top marginal rates and the income tax in the 1930s under FDR. We peaked at 79% for a good while after the New Deal and really retained rates in that kind of vicinity into the 1970s, and Piketty's whole argument is that these rates succeeded in knocking down the capital stock, which is kind of the core of his theory, knocked down the mid-20<sup>th</sup>-century capital stock and brought about an equalizing trend, and then ever since we repealed these rates, inequality has been on the rise again.

So to construct this narrative, he has to tie it in to a very specific set of political events. And what we found is the story he tells about the 1920s and 1930s falls far more on partisan lines than on historical lines to the extent that he bends the years in presidential administrations that he credits for specific tax events. We really start in the mid-1920s, you know, in 1925, Calvin Coolidge passed through a major income tax cut that brought the top rates down to about 25%. Well, Piketty actually attributes this to Herbert Hoover as something that's taking place on the eve of the Great Depression. So it fits into that narrative, when the reality is the exact opposite. Hoover inherited the low rates from Calvin Coolidge and then hiked them himself after the onset of the Great Depression in 1932 upward to 63%. Then FDR comes on a couple of years later and hikes them again to 79%. So Piketty's got his entire history of this era backwards, but it operates in such a way that makes the Republican president, Hoover, look like he's this kind of laissez-faire, free market type whereas FDR is the friend of the poor man, the great progressive liberal that therefore gets all the credit for this tax policy that Piketty thinks is the pioneering basis of what we should revive in this global wealth tax.

**WOODS:** Let's talk about the minimum wage issue here, and here I want to quote from your paper, and I was telling you before we went on: one of the things I really like about this paper is the prose. The prose is extremely elegant in this paper. It reads, of course, as you would expect, an academic paper to read, but because the prose is so elegant, that makes the indignant remarks, the outrage of the authors all the more biting because it's delivered in such a scholarly way. In other words, the authors have certain scholarly expectations of this book that they're critiquing, and the book falls so far short of this that you have this tempered, but nevertheless, scholarly outrage.

After quoting from his book and talking about the minimum wage, you then say, “Here again this ‘history’ is utterly wrong, as readily available federal sources reveal. Piketty’s description above is so at odds with the actual history that it is easiest if we present the correct information in a table.” So we can’t just fix one figure. We had to chuck the whole thing. So what is the story he’s telling? What’s the real story? And how does this, again, fit into his thesis?

**MAGNESS:** So, again, he’s taking up the issue of the minimum wage, and he has this passage where he lays out the supposed history of minimum wage legislation in the United States. He says that, “The federal minimum wage from 1980 to 1990 under Ronald Reagan and George H.W. Bush remains stuck at \$3.35 an hour,” is the base minimum. And he attributes to this a significant decrease in purchasing power when inflation is factored in. It also fits into his progressive narrative. He’s a basic guaranteed income type of a guy. Then he jumps in—the Clinton Administration takes over and Piketty claims that Clinton, to his credit—this is something he approves of—raises the minimum wage to \$5.25, but then it’s frozen again under George W. Bush until Barack Obama comes along and, of course, raises the minimum wage again. Well, we went back and just pulled the basic, readily available tables of historical minimum wage data from the U.S. Department of Labor, and he’s got his entire narrative wrong.

In fact, we have two minimum wage hikes that took place under George Herbert Walker Bush’s administration in 1990 and again in 1991. Bill Clinton did raise the minimum wage in his own right in ’96 and ’97. But then George W. Bush enacts a subsequent minimum wage increase in 2007 followed by another in 2009. Then the one that Piketty attributes to Barack Obama in 2009 is actually a piece of legislation that was passed in the Bush Administration. So Obama really had nothing to do with it than, I guess, voting for it in the Senate, but it was an inherited policy. And again, this is not to say that a minimum wage hike is a good thing. I think there are serious economic problems with that, but the tale that Piketty is telling for his history is contrived in such a way that it basically makes the Republican presidents look like they are, again, *laissez faire* types, non-interventionists, who don’t care about the poor people, but Bill Clinton and Barack Obama—they come in and correct the stagnation and the mistakes of the previous years.

**WOODS:** Before we continue, Phil, first of all, I want to tell people that they can read your paper over on the show notes page for this episode. This episode being number 318, it will be [TomWoods.com/318](http://TomWoods.com/318). We’ll link to that. We’ll have a link to *Capital in the 21<sup>st</sup> Century* as well.

I want to pause for a moment and have you say something about some of the media attention that this paper has already received—even though you can read it online, it has not yet been published as I understand it in *The Journal of Private Enterprise* yet.

**MAGNESS:** Right, so it should be in the upcoming, spring issue of *The Journal of Private Enterprise*. Actually, I expect it out probably around April. But we put the paper online. It’s on the Social Science Research Network, which is normally a scholarly research sharing site, and

most papers that go onto that generate a little bit of commentary in the scholarly community, but very few of them burst over into the public scene. We were very fortuitous in this respect. I posted the paper just before the new year when we had the draft out. We had the version submitted to *The Journal of Private Enterprise*, and we're ready to go on it, and slowly, over the next couple of days made the rounds in academic communities on email discussions. Then I'm sitting at home one night, and I get an email, and it's a reporter from Fox News. He was doing a story on Piketty. One of the events that kind of brought that to the forefront is that there was a session at the American Economic Association about two weeks ago at the beginning of January on Piketty's book, including some papers that had challenged various aspects of it, and he noted that this new paper that we released was echoing some of the same themes and adding to that discussion. So he wanted to do a story on it. I talked to the reporter. A day later, one story's up. Then it's picked up by some other newspapers. *The Christian Science Monitor* contacted us the next day with its own story, and it kind of exploded from there.

**WOODS:** As a matter of fact, Piketty himself was confronted by, I guess, the Fox News person with your paper.

**MAGNESS:** Right.

**WOODS:** And he tried to respond, well, almost sarcastically: I am really sorry if I mistook one U.S. president for another, but I don't think there's any big problem with my work that challenges my thesis, but of course, what you've done in this paper we haven't even gotten to the really devastating stuff. This ain't no typo.

**MAGNESS:** Exactly, and that's the words he used. He said, well, there's a few typos, and I'll correct them in the next version of the book, and my answer to that would be you have quite a few corrections to make.

**WOODS:** Yeah, quite a few corrections to make. I read this paper just today over lunch to get ready for our conversation, and I was marking it up and noting, oh, this is an interesting methodological problem here, or he has a strange way of selecting data here, or in this case, he's just filling in little data points that don't exist just to fill up space between the two points that do exist, and so I thought we'd go through one by one, but then I thought why don't you spell out a few of the examples of his methodological problems that should be red flags for researchers.

**MAGNESS:** Yeah, absolutely. So if you read the opening chapter even of the book, he makes variable data claims. They are nuanced, but they are bold. He keeps saying that this is the most extensive assemblage of data that's ever been brought to bear on this problem. He admits with that that, yeah, there are going to be gaps because he's covering multiple centuries, as he says, and he also says he's covering something like 30 different countries that he's investigated. That's a bit of a bold claim. As we really look into the data, he only consistently probes the United States, the U.K., and France, and then sometimes ventures into Germany and Sweden, and he only really consistently in depth explores from about 1900 onward. There are few data

points before that, but that's kind of the window we're looking at is the 20<sup>th</sup> century—the dawn of the 20<sup>th</sup> century up to the present. Nonetheless, he makes some very bold data claims and says that we need to let the science of the data tell us what's going on and build our theory from there. I would argue he actually does quite the opposite in the book. I argue that he is very convinced of his own interpretation of why inequality happens and what the political implications of that happen to be, and he often looks backwards for data points that can try to confirm this narrative he's already constructed, whether it's in his head or in his previous research.

He's constructed this narrative of the 20<sup>th</sup> century where we start out with high inequality. Events like World War I and the Great Depression and World War II, and above all else, the adoption of progressive income taxation knocks down the top 1%. They knock down the capital hoarders—the rentier class. By the mid-century, they equalize everything. Everything is going along fine until 1970s and 1980s you start getting political changes. People like Margaret Thatcher in the U.K., Ronald Reagan in the United States come in and what do they do? They cut taxes. They liberalize at least that portion of fiscal policy. Piketty's narrative then has to demonstrate that inequality has risen as a response to these tax cuts essentially, and his corrective is to come in and say we need higher taxes. So he goes back and tries to investigate this question with this narrative already in mind, and he looks for different points of data that are supposed to tell us this story. To give you a couple of examples, so he goes into some metrics of wealth inequality on a country-by-country basis. He looks at the United States, he looks at the U.K., France, a couple of other places around the world, and his big, recurring theme is that the 20<sup>th</sup> century looks like a U if you were to map it all out—high inequality at the beginning of the century. Taxes and all these other events come in. Things equalize at mid-century, and now, inequality is back on the rise again from about 1980 onward.

To get to his data points there, he automatically encounters problem number one, and that is we do not have a complete, thorough, worldwide or even nationwide dataset of something that could attest to what the wealth distribution happens to be across the century. Problem number two is where those estimates have been attempted, and it's mostly only in a few very developed economies like the U.S., the U.K., and France. There's quite a bit of methodological discretion at play. In other words, there are scholars that have studied this question through different estimation techniques, and the results they get are not at all clear in supporting the trend line that he wants to show. So that's where he starts putting his finger on the scale. That's where he starts picking and choosing between datasets to kind of build a larger story that fits his narrative, but isn't necessarily supported in some of the core data.

**WOODS:** Well, you have one graph in here, and I don't remember exactly because there's so many of them I don't remember which one this is, but it's one where it's showing the results of a whole bunch of different studies pertaining to, I guess, inequality, and then he's going to try to aggregate these. You would think his result of aggregating them would be somewhere in the middle of all of these studies. His result is way, way above all of them. How could that be?

**MAGNESS:** Yeah, that's the interesting thing. I think that's figure 5 in our paper that you're referring to right there. Figure 5 is a construction that we made to try and reassemble one of the core pieces of evidence that Piketty brings to bear in his own study, and this is Piketty's own figure, 10.5 if you're referring to his book, it's a century-long trend line of wealth and inequality in the United States. He wants to tell how the wealth shares are distributed. So he looks at how much wealth is owned by the top 1% and the top 10%, and his trend line looks like that U I just described. I started digging around in some of the source data where he claimed to get his numbers to put together this trend line because as you said, it's an aggregate of about six or seven different studies. And it's not at all very well annotated neither in the book, nor the Excel files that he posted online. There's all this acclaim. He said he was transparent on his data because he posted it online, which is great, and I'll give him credit for that. I appreciate the fact that he did it, but if you look into his own charts that he puts online, they aren't cited well, they are missing references—numbers that seem to just kind of come out of thin air all over the place. So it's opaque in that sense.

In our reconstruction of this main chart in figure 10.5 what we found is from the turn of the century through the 1950s, he uses one theory. This is a well-regarded, estate tax based estimate of wealth distributions in the U.S., and this is by Kopczuk and Saez in 2004. So the Kopczuk and Saez paper is kind of the core estate tax estimate for the U.S. He gets to the 1960s, and he switches to an entirely different study with a different methodology. This is based on the Federal Reserve's *Survey of Consumer Finances* by Ed Wolf, which comes up with a different number, and he gets to the 1970s, he switches back to Kopczuk and Saez. This is important in the 1970s because Kopczuk and Saez dataset shows that year as the bottom point of inequality in the United States. It's the least unequal period in 20<sup>th</sup> century history for the United States in their dataset. So he gets a trough to his U for the 1970s by selecting this one particular study, and even though that same study continues on through the 1980s, when taken alone, it shows a really interesting trend. So Kopczuk and Saez in 2004 in this published report that's really kind of industry standard show that wealth and equality is actually flat from 1980 up until 2004 is when their study came out. So 1980 up until very close to the present day, they showed there's no real increase in inequality at all using their study. That's the first problem that Piketty has. He can't continue to rely on that data series. So what does he do? He switches to another one that shows more of an uptick. He pulls in a different study for the 1980s that shows a divergence in the trend. That gets him to the beginning of the rebound in the U. Then he switches to another study for the 1990s and another study for the 2000s. So he's just picking and choosing from all these different estimation techniques to pad in his chart and tell the story that the raw data will not show and does not show when taken alone.

**WOODS:** And then it seems like there are cases where he's trying to do something for which really robust data is simply unavailable, and this would make a lot of researchers say, well, then maybe it's not worth doing, or we would have to put a very, very serious caveat in place, but instead, it seems to give him *carte blanche* to engage in massaging of the data, of extrapolation. I'm just looking at your figure 10, which is a depiction of one of his tables. This is Piketty's world

output distribution source charts, and you say beneath this chart, “While remaining fully cognizant that data limitations do indeed impinge on our ability to assemble a comprehensive, multi-century time series of this sort, to use only six individual years for a 150-year examination is almost as astounding as it is incomprehensible.” Ouch.

**MAGNESS:** Right, that’s a really interesting chart because he’s attempting to—he’s testing his theory worldwide, and he has this famous, acclaimed equation of  $r > g$ ,  $r$  being the return on capital will exceed growth based on income. His argument is this is the source of inequality, the explanation of inequality. So to prove this, he attempts to construct a worldwide index of capital ownership, and in order to do that, he’s going to pull all these different datasets from different countries. He hits a problem immediately because a lot of the data simply isn’t available, but in order to construct it, he has to weight each country to tell how much of world output at that given point in history came from the United States, how much belonged to Europe, how much belonged to Russia, how much belonged to China. So his weights are all based on the distribution of basically world outputs—GDP figures for a given year, and rather going back and actually getting that data in any robust sense, he makes it up. He fills it in. So the most grievous example—because he has one data point for 1910. Actually, it comes from a study of the world economy in 1913, and then he has a gap for the next three and a half decades and doesn’t have his next distribution recalibration point until 1950. So I’ll ask the question: what happened between 1910 and 1950 in the world economy and other world events?

**WOODS:** Yeah, right, only the most momentous events in the history of Western civilization.

**MAGNESS:** Exactly, and not only that, they are the exact same events that he credits in his book to being this disruptive trend that knocks down the capital stock and equalizes the world, and he doesn’t even have the data.

**WOODS:** I want to ask you about this point about the communist-era effect on the data. Can you explain what that’s all about?

**MAGNESS:** Yeah, and this is related to this same chart. He attempts this global index of the capital stock, and it’s the capital to national income ratio for the world. He only really has decent data for western Europe and North America for the whole 20<sup>th</sup> century. When you get toward 1970 and beyond, you start to pick up things like Japan, Australia, New Zealand have reliable numbers, but the rest of the world is either ambiguous or the records simply aren’t there to support a calculation of this distribution. So he goes in and he backfills it by guestimation. You can debate whether that’s a valid technique or not, but nonetheless, he does it. So the parts of the world that are not covered in western Europe and North America are basically backfilled in by his own guestimates. I was digging around in this chart to try and figure out exactly what he did and what gave it its shape. Again, it’s got this U-shaped trend. So the capital stock disappears around 1950, or it reduces dramatically around 1950, and then it’s been on the rebound since about 1980, according to his portrayal. So I noticed something very

strange in looking at his source data. It wasn't annotated. It's not explained in the book and anything connected to the chart. It's not in any of his footnotes.

So when he's going back and guestimating all these numbers for the different regions of the world, when he gets to places like the Soviet Union, rather than showing a parallel reduction in the capital stock that mirrors western Europe or mirrors North America, he obliterates it. He drops the ratio to one-to-one parity between the private capital stock of the Soviet Union and its national income output, and what this effectively means he's doing is he's accepting as an *a priori* the communist ideological point that they have abolished private capital. He's accepting when the Soviets say that we have created a worker's paradise and abolished the capital stock, that is indeed so. Therefore, we can reduce that capital stock to parity, and he hard codes this assumption into his charts.

So this gives me two questions. The first one is how prudent is it to accept that communist ideological point in any basis as a reflection of reality? We know that inequality is severe in the Soviet Union. We know it's severe in eastern Europe during the communist years. We know it's extremely severe in Maoist China. So why make that assumption in the first place? It's not really in sync with anything else he's trying to tell in the chart. And the second thing, this is supposed to be a representation of a global rule about the behavior or capitalism. Why is he included communist data points in a chart about capitalism at all in the first place and then making interpretations that are supposed to tell us some innate characteristic of a capitalist market economy over the 20<sup>th</sup> century? And the problem is when he adds this assumption in, it creates a distortive effect that pulls down the U at the mid-century point exactly in sync with this political narrative he's told.

**WOODS:** Now one thing that you guys are doing, as it were, incidentally in the course of your presentation is a review of the literature on this general subject, and what you're finding is that you do find some scholars who say there's been a mild uptick in terms of inequality, and then there are some more ambiguous results, but what you don't find is an absolute, 98% consensus that this is what's happening, and certainly, no consensus as to why it might be happening. Even that it is happening is disputed, and yet Piketty makes it seem as if the story he's telling is really something everybody knows; he's just providing the theoretical apparatus to account for it. But it's not something everybody knows.

**MAGNESS:** Right, right. I think that's an entirely fair point. We did review quite a bit of the inequality literature, including the studies that are supposedly the base of Piketty's numbers — all the studies that he draws data out of, and if you look at them in cumulative, and you look at them in any depth, you find that all of the conclusions that are drawn out of them are very measured. Some of them suggest that inequality trends are relatively flat, especially over the last 30 years or so. Others should suggest a slight uptick. It's very, very modest, and it's jagged. It's not the smooth and very clear line that Piketty portrays in his book. Rather, it's ambiguous all around. I'd say an honest assessment of that literature would ask the question what do we know about wealth inequality in the United States of the past 30 years or other part of the



world—some of the same issues are at play. An honest scholar would look at that and say, well, there are some interesting trends that seem to be emerging, but they're very imprecise. It's very ambiguous. If we estimate it this one way, there looks to be a slight increase. If we estimate it this other way, it looks to be completely flat.

So the scholarly answer is we don't know. We don't know. The verdict is still out, and there's probably more to be done in studying this issue. If you ask Piketty, he is absolutely certain that inequality is on the rise. And again, I mentioned Paul Krugman earlier wrote one of his articles of praise after this book came out and said, well, anyone that doubts that inequality is on the rise is an inequality denier, and they are just like the climate change deniers. Now, that's a fault on Krugman's part because he's not fully assessing what the academic literature happens to say and where that academic literature stands right now. Again, I'd urge anyone that's interested in the subject, we try to cite as many studies, including competing studies, on this subject matter and explain where some of the divergences occur, but the point to take away is not that Piketty has missed a complete trend line, and we have the absolute certain answer to it. Rather, the point to take away is that the academic verdict is still out.

**WOODS:** Phil, how is it that you came to do this? This is a very intimidating looking book. It's huge. It's full of all this data. What would possess somebody to say, I am going to start looking in detail and see if these numbers are accurate or the way he assembled them is kosher and all that? Where on Earth did the motivation from that come from, man?

**MAGNESS:** Oh, yeah, it's an interesting story. So Piketty's book came out. I want to say it was last March or April. It was very early in the publicity emerged around it before all the big reviews had come out. Several faculty colleagues mentioned it to me, and just in passing I'd see them in the hallway on the way to class or something, and they'd say, hey, have you seen this new book. And I was like, no, what is it? Well, it's an economist who assembles aggregate tax data, and this is how it was presented to me. A little background to some of your readers: I am a historian of the 19<sup>th</sup> century United States, and one of the areas I work on is historical tax policy—so tariff revenues from the Civil War to the income tax era are kind of my bread and butter. I've studied those datasets inside and out—know where the upticks on tax revenue happen to be and where they decline. I also know quite a bit about the early income tax era.

So the adoption of the federal income tax in 1913 through the Great Depression. I've seen all those numbers inside and out, and because of this, I had faculty colleagues saying, hey, you ought to take a look at this book. It seems like there's some overlapping area for you. I'd be interested in what your take is. So I started poking around a little bit in it, and some things kind of seemed fishy. In particular he had this chart showing the revenue returns to the United States from various tax policies from 1870 up until the present day, and naturally, being a 19<sup>th</sup>-century guy, I start looking at his tax data around 1870, and the picture he's showing doesn't look at all like what I'm familiar with. So I opened up his Excel chart, and I found not only did it not look like what I'm familiar with, but there's a specific reason for this. He had basically backdated and filled in his numbers from 1870, 1880, 1890, and 1900—just *ex nihilo*, out of

nothing. He didn't have accurate data for that, and to bring it into consistency with other parts of his charts, he went in and just basically made things up to make it look pretty. So that kind of tipped me off that maybe there's something a little fishy about this. Jump forward a couple of weeks, and the *Financial Times* published a major story in late May where they challenged some other aspects of Piketty's data work, including some of the inequality figures, and between knowing what I had seen on the tax data and knowing what the *Financial Times* was raising on the inequality figures, I started wondering maybe there were more problems like this scattered throughout his dataset. So I went to some of the main charts and started poking around a little bit. Not much longer after that, it became readily evident that there are quite a few discretionary decisions that he undertakes that are not kosher. They are not very standard for just the basics of statistical methodology, especially when you're dealing with historical time series. And as a result, you get a very clear divergence between what the numbers actually say and how he's presenting them.

**WOODS:** Well, the paper is called *Challenging the Empirical Contribution of Thomas Piketty's Capital in the 21<sup>st</sup> Century*. We're linking to it on the show notes [TomWoods.com/318](http://TomWoods.com/318), and people can follow you at your website [PhilMagness.com](http://PhilMagness.com). Phil, thanks so much for your time today and for this tireless work—punishing work. But now I hope you feel like it's very rewarding work. It's not even technology fully in print. You can get it online, but it's not in print yet, and it's already having an influence. So congratulations.

**MAGNESS:** Thank you.