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Piketty's Numbers Don't Add Up

Ignoring dramatic changes in tax rules since 1980 creates the false impression that income inequality is rising.

By Martin Feldstein

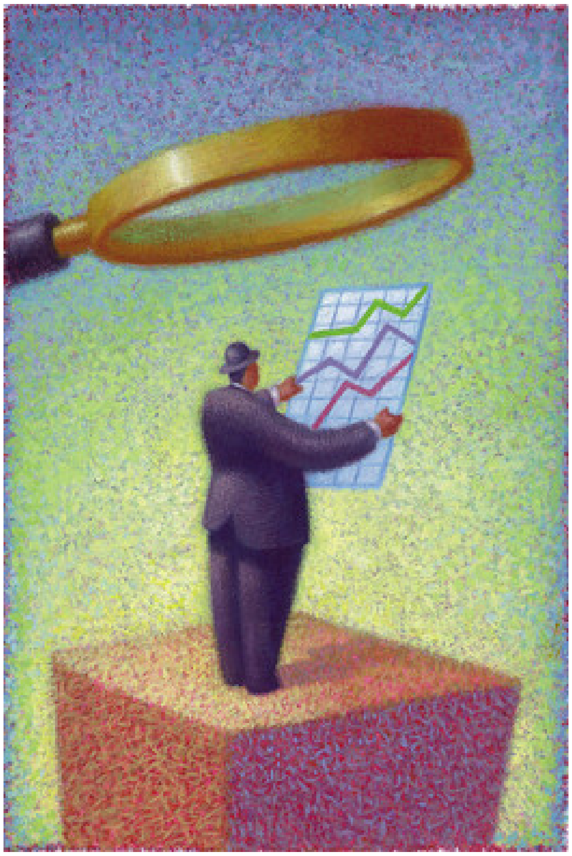
May 14, 2014 7:31 pm ET

Thomas Piketty has recently attracted widespread attention for his claim that capitalism will now lead inexorably to an increasing inequality of income and wealth unless there are radical changes in taxation. Although his book, "Capital in the Twenty-First Century," has been praised by those who advocate income redistribution, his thesis rests on a false theory of how wealth evolves in a market economy, a flawed interpretation of U.S. income-tax data, and a misunderstanding of the current nature of household wealth.

Mr. Piketty's theoretical analysis starts with the correct fact that the rate of return on capital—the extra income that results from investing an additional dollar in plant and equipment—exceeds the rate of growth of the economy. He then jumps to the false conclusion that this difference between the rate of return and the rate of growth leads through time to an ever-increasing inequality of wealth and of income unless the process is interrupted by depression, war or confiscatory taxation. He advocates a top tax rate above 80% on very high salaries, combined with a global tax that increases with the amount of wealth to 2% or more.

His conclusion about ever-increasing inequality could be correct if people lived forever. But they don't. Individuals save during their working years and spend most of their accumulated assets during retirement. They pass on some of their wealth to the next generation. But the cumulative effect of such bequests is diluted by the combination of existing estate taxes and the number of children and grandchildren who share the bequests.

The result is that total wealth grows over time roughly in proportion to total income. Since 1960, the Federal Reserve flow-of-funds data report that real total household wealth in the U.S.



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has grown at 3.2% a year while the real total personal income calculated by the Department of Commerce grew at 3.3%.

The second problem with Mr. Piketty's conclusions about increasing inequality is his use of income-tax returns without recognizing the importance of the changes that have occurred in tax rules. Internal Revenue Service data, he notes, show that the income reported on tax returns by the top 10% of taxpayers was relatively constant as a share of national income from the end of World War II to 1980, but the ratio has risen significantly since then. Yet the income reported on tax returns is not the same as individuals' real total income. The changes in tax rules since 1980 create a false impression of rising inequality.

In 1981 the top tax rate on interest, dividends and other investment income was reduced to 50% from 70%, nearly doubling the after-tax share that owners of taxable capital income could keep. That rate reduction thus provided a strong incentive to shift assets from low-yielding, tax-exempt investments like municipal bonds to higher yielding taxable investments. The tax data therefore signaled an increase in measured income inequality even though there was no change in real inequality.

The Tax Reform Act of 1986 lowered the top rate on all income to 28% from 50%. That reinforced the incentive to raise the taxable yield on portfolio investments. It also increased other forms of taxable income by encouraging more work, by causing more income to be paid as taxable salaries rather than as fringe benefits and deferred compensation, and by reducing the use of deductions and exclusions.

The 1986 tax reform also repealed the General Utilities doctrine, a provision that had encouraged high-income individuals to run their business and professional activities as Subchapter C corporations, which were taxed at a lower rate than their personal income. This corporate income of professionals and small businesses did not appear in the income-tax data that Mr. Piketty studied.

The repeal of the General Utilities doctrine and the decline in the top personal tax rate to less than the corporate rate caused high-income taxpayers to shift their business income out of taxable corporations and onto their personal tax returns. Some of this transformation was achieved by paying themselves interest, rent or salaries from their corporations. Alternatively, their entire corporation could be converted to a Subchapter S corporation whose profits are included with other personal taxable income.

These changes in taxpayer behavior substantially increased the amount of income included on the returns of high-income individuals. This creates the false impression of a sharp rise in the incomes of high-income taxpayers even though there was only a change in the legal form of that income. This transformation occurred gradually over many years as taxpayers changed their behavior and their accounting practices to reflect the new rules. The business income of Subchapter S corporations alone rose from $500 billion in 1986 to $1.8 trillion by 1992.

Mr. Piketty's practice of comparing the incomes of top earners with total national income has another flaw. National income excludes the value of government transfer payments including Social Security, health benefits and food stamps that are a large and growing part of the personal incomes of low- and middle-income households. Comparing the incomes of the top 10% of the population with the total personal incomes of the rest of the population would show a much smaller rise in the relative size of incomes at the top.

Finally, Mr. Piketty's use of estate-tax data to explore what he sees as the increasing inequality of wealth is problematic. In part, this is because of changes in estate and gift-tax rules, but more fundamentally because bequeathable assets are only a small part of the wealth that most individuals have for their retirement years. That wealth includes the present actuarial value of Social Security and retiree health benefits, and the income that will flow from employerprovided pensions. If this wealth were taken into account, the measured concentration of wealth would be much less than Mr. Piketty's numbers imply.

The problem with the distribution of income in this country is not that some people earn high incomes because of skill, training or luck. The problem is the persistence of poverty. To reduce that persistent poverty we need stronger economic growth and a different approach to education and training, not the confiscatory taxes on income and wealth that Mr. Piketty recommends.

Mr. Feldstein, chairman of the Council of Economic Advisers under President Ronald Reagan, is a professor at Harvard and a member of the Journal's board of contributors.