Reynolds (WSJ) vs Piketty-Saez

Original article by Alan Reynolds

The Top 1% . . . of What?
By ALAN REYNOLDS
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As many others have done, Virginia's Democratic Senator-elect Jim Webb recently complained on this page of an "ever-widening divide" in America, claiming "the top 1% now takes in an astounding 16% of national income, up from 8% in 1980." Those same figures have been repeatedly echoed in all major newspapers, including this one. Yet the statement is clearly false. The top 1% of households never received anything remotely approaching 16% of personal income (national income includes corporate profits). The top 1% of tax returns accounted for 10.6% of personal income in 2004. But that number too is problematic.

The architects of these estimates, Thomas Piketty of École Normale Supérieure in Paris and Emmanuel Saez of the University of California at Berkeley, did not refer to shares of total income but to shares of income reported on individual income tax returns -- a very different thing. They estimate that the top 1% (1.3 million) of taxpayers accounted for 16.1% of reported income in 2004. But they explicitly exclude Social Security and other transfer payments, which make up a large and growing share of total income: 14.7% of personal income in 2004, up from 9.3% in 1980. Besides, not everyone files a tax return, not all income is taxable (e.g., municipal bonds), and not every taxpayer tells the complete truth about his or her income.

For such reasons, personal income in 2004 was $3.3 trillion, or 34.4%, larger than the amount included in the denominator of the Piketty-Saez ratio of top incomes to total incomes. Because that gap has widened from 30.5% in 1988, the increasingly gigantic understatement of total income contributes to an illusory increase in the top 1%'s exaggerated share.

The same problems affect Piketty-Saez estimates of share of the top 5%, which contradict those from the Census Bureau (which also exclude transfer payments). Messrs. Piketty and Saez figure the top 5%'s share rose to 31% in 2004 from 27% in 1993. Census Bureau estimates, by contrast, show the top 5%'s share of family income fluctuating insignificantly from 20% to 21% since 1993. The top 5%'s share has been virtually flat since 1988, aside from a meaningless one-time jump in 1993 when, as the Economic Policy Institute noted, "a change in survey methodology led to a sharp rise in measured inequality."

Unlike the Census Bureau, Messrs. Piketty and Saez measure income per tax unit rather than per family or household. They maintain that income per tax unit is 28% smaller than income per household, on average. But because there are many more two-earner couples sharing a joint tax return among high-income households, estimating income per tax return exaggerates inequality per worker.

The lower line in the graph shows that the amount of income Messrs. Piketty and Saez attribute to the top 1% accounted for 10.6% of personal income in 2004. That 10.6% figure looks much higher than it was in 1980. Yet most of that increase was, as they explained, "concentrated in two years, 1987 and 1988, just after the Tax Reform Act of 1986." As Mr. Saez added, "It seems clear that the sharp, and unprecedented, increase in incomes from 1986 to 1988 is related to the large decrease in marginal tax rates that happened exactly during those years."

That 1986-88 surge of reported high income was no surprise to economists who study taxes. All leading studies of "taxable income elasticity," including two by Mr. Saez, agree that the amount of income reported by high-income taxpayers is extremely sensitive to the marginal tax rate. When the top tax rate goes way down, the amount reported on tax returns goes way up. Those capable of earning high incomes had more incentive to do so when the top U.S. tax rate dropped to 28% in 1988 from 50% in 1986. They also had less incentive to maximize tax deductions and perks, and more incentive to arrange to be paid in forms taxed as salary rather than as capital gains or corporate profits.

The top line in the graph shows how much of the top 1%'s income came from business profits. In 1981, only 7.8% of the income attributed to the top 1% came from business, because, as Mr. Saez explained, "the standard C-corporation form was more advantageous for high-income individual owners because the top individual tax rate was much higher than the corporate tax rate and taxes on capital gains were relatively low." More businesses began to file under the individual tax when individual tax rates came down in 1983. This trend became a stampede in 1987-1988 when the business share of top percentile income suddenly increased by 10 percentage points. The business share increased again in recent years, accounting for 28.4% of the top 1%'s income in 2004.

As was well-documented years ago by economists Roger Gordon and Joel Slemrod, a great deal of the apparent increase in reported high incomes has been due to "tax shifting." That is, lower individual tax rates induced thousands of businesses to shift from filing under the corporate tax system to filing under the individual tax system, often as limited liability companies or Subchapter S corporations.

IRS economist Kelly Luttrell explained that, "The long-term growth of S-corporation returns was encouraged by four legislative acts: the Tax Reform Act of 1986, the Revenue Reconciliation Act of 1990, the Revenue Reconciliation Act of 1993, and the Small Business Protection Act of 1996. Filings of S-corporation returns have increased at an annual rate of nearly 9.0% since the enactment of the Tax Reform Act of 1986."

Switching income from corporate tax returns to individual returns did not make the rich any richer. Yet it caused a growing share of business owners' income to be newly recorded as "individual income" in the Piketty-Saez and Congressional Budget Office studies that rely on a sample of individual income tax returns. Aside from business income, the top 1%'s share of personal income from 2002 to 2004 was just 7.2% -- the same as it was in 1988.

In short, income shifting has exaggerated the growth of top incomes, while excluding a third of personal income (including transfer payments) has exaggerated the top groups' income share.

There are other serious problems with comparing income reported on tax returns before and after the 1986 Tax Reform. When the tax rate on top salaries came down after 1988, for example, corporate executives switched from accepting stock or incentive stock options taxed as capital gains (which are excluded from the basic Piketty-Saez estimates) to nonqualified stock options reported as W-2 salary income (which are included in the Piketty-Saez estimates). This largely explains why the top 1%'s share rises with the stock boom of 1997-2000 then falls with the stock market in 2001-2003.

In recent years, an increasingly huge share of the investment income of middle-income savers is accruing inside 401(k), IRA and 529 college-savings plans and is therefore invisible in tax return data. In the 1970s, by contrast, such investment income was usually taxable, so it appears in the Piketty-Saez estimates for those years. Comparing tax returns between the 1970s and recent years greatly understates the actual gain in middle incomes, and thereby contributes to the exaggeration of top income shares.

In a forthcoming Cato Institute paper I survey a wide range of official and academic statistics, finding no clear trend toward increased inequality after 1988 in the distribution of disposable income, consumption, wages or wealth. The incessantly repeated claim that income inequality has widened dramatically over the past 20 years is founded entirely on these seriously flawed and greatly misunderstood estimates of the top 1%'s alleged share of something-or-other.

The politically correct yet factually incorrect claim that the top 1% earns 16% of personal income appears to fill a psychological rather than logical need. Some economists seem ready and willing to supply whatever is demanded. And there is an endless political demand for those able to fabricate problems for which higher taxes are, of course, the preferred solution. In Washington higher taxes are always the solution; only the problems change.

Mr. Reynolds, a senior fellow with the Cato Institute, is the author of "Income and Wealth" (Greenwood Press, 2006).

Response by
Thomas Piketty and Emmanuel Saez to:
The Top 1% . . . of What?
By ALAN REYNOLDS

In his December 14 article, "The Top 1% ... of What?", Alan Reynolds casts doubts on the interpretation of our results showing that the share of income going to the top 1% families has doubled from 8% in 1980 to 16% in 2004. In this response, we want to outline why his critiques do not invalidate our findings and contain serious misunderstandings on our academic work.

First and most important, Alan Reynolds points out that, in contrast to our results, the official Census Bureau figures show only a modest increase in the top 5% income share. The reason for the discrepancy is that the Census Bureau estimates are based on survey data which are not suitable to study high incomes because of small sample size and top coding of very high incomes. In contrast, tax return data provide a very accurate picture of reported incomes at the top. Our key contribution was precisely to use those tax data to construct better inequality estimates. We found that only families within the top 1% experienced very large gains relative to the average since 1980 and that upper middle class families (the next 4% below the top 1%) experienced only modest gains (similar to the modest increases found in the Census Bureau figures for the top 5%). This shows that the Census Bureau figures, based on data which cannot measure top 1% incomes, misses the extraordinary gains going to the top 1%, which is perhaps the most striking change in the US income distribution in recent decades.

Second, Alan Reynolds asserts that our estimates are upward biased because our total income measure is smaller than personal income from National Income and Products Accounts. Our measure of income is cash market income defined as gross income reported on tax returns less government transfers such as Social Security or Unemployment Insurance. Personal income is a broader measure of income which also includes non-cash market income such as fringe benefits from employers, imputed rent for homeowners, under-reported income (due to tax evasion) but also government transfers such as Medicare, Social Security. Conceptually, it makes more sense to focus either on market income (before deducting taxes and including transfers) or on disposable income (market income net of taxes and including transfers). We chose to estimate inequality based on (cash) market income but it would certainly be interesting to estimate inequality based on disposable income as well to assess the effects of government taxes and transfers on inequality. The official concept of personal income is not appropriate for either computation because it mixes market income with transfers but does not subtract taxes. Alan Reynolds points out that transfers have increased since 1980 but taxes on high incomes have decreased substantially. Actually, we have estimated that the average Federal tax burden on top 1% families has decreased from 44.4% in 1980 to 30.4% in 2004. The decrease in taxes at the top outweighs the increase in transfers at the bottom. Therefore, the top 1% disposable income share has most likely more than doubled since 1980.

Third, Alan Reynolds points out that reported incomes may not reflect true incomes because of tax evasion or tax avoidance. This is a legitimate concern and we, along with a number of colleagues, have actually spent substantial time investigating this issue. Alan Reynolds has picked some of the facts in order to provide a very skewed view. Most of the scenarios described by Alan Reynolds, such as a shift from corporate income to individual income or from qualified stock-options to non-qualified stock options, would imply that high incomes used to receive capital gains instead of ordinary income. For example, a closely held C-corporation which does not distribute its profits increases in value and those accumulated profits would appear as realized capital gains on the owner individual tax return when the business is sold. Yet, our top 1% income share series including realized capital gains has also doubled from 10.0% in 1980 to 19.8% in 2004.

In contrast to what Alan Reynolds suggests, there is a debate among economists on whether reported incomes respond to tax rates. The emerging consensus is that there can be substantial responses in the short-run due to retiming of income such as realizing capital gains before a tax rate increase, but that the long-term response is small. For example, as shown by Austan Goolsbee at the University of Chicago, the Clinton 1993 top rate increase from 31% to 39.6% did induce executives to exercise their stock-options in 1992 instead of 1993 but executive pay resumed its dramatic surge after 1994. Indeed, our series focusing exclusively on W2 wage and salary income (therefore excluding both business income and capital income), show that the top 1% wage income share has increased from 6.4% in 1980 to 11.6% in 2004, no doubt a very large increase as well. There is a very large literature on executive compensation and one point of agreement is that executive pay has surged relative to average pay over the last two decades, whether one counts stock-options when exercised or when granted, or even if one excludes stock-options entirely.

Even the small point on 401(k)s is conceptually mistaken: pension income is reported on tax returns when withdrawn during retirement and hence returns on pension funds are implicitly included in our income measure. Furthermore, before 401(k)s where introduced in the 1980s, workers had traditional Defined Benefits pensions which also generated capital income which were not reported on tax returns before retirement.

In sum, our work has shown the top 1% income share has increased dramatically in recent decades and has reached levels which had not been seen since before World War II and even since before the Great Depression when including capital gains. The reduction in taxes at the top since 2001 has mechanically exacerbated the discrepancy in disposable income between the rich and the rest of us. Thus, it is obvious that the progressive income tax should be the central element of the debate when thinking about what to do about the increase in inequality. Even conservatives like Alan Reynolds would agree and that is why they prefer to dismiss the facts about growing income inequality rather than face the debate on income tax progressivity at a time of growing economic disparity.

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