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Don't Hurt Entrepreneurship In Fighting Income Inequality

By Scott Shane

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In his best-selling new book “Capital in the 21st Century,” Thomas Piketty of the Paris School of Economics calls for a progressive wealth tax to combat rising income and wealth inequality. While I admire Professor Piketty’s fantastic scholarly work, I have concerns about his solution, which will reduce entrepreneurship.

Professor Piketty’s careful analysis of Internal Revenue Service (IRS) data (conducted with his colleague Emanual Saez of the University of California at Berkeley) shows that the share of income (excluding capital gains) accounted for by the top 1 percent of Americans hit 19.3 percent in 2012, up from 18.3 percent in 2007, and nearly back to the record of 19.6 percent achieved in 1928. As the two French economists have pointed out, the fraction of income belonging to the top one percent also has more than doubled since 1980, following a long period of decline from 1928 to 1973.

However, the share of income going to the top one percent is not the only change that has occurred over the past 30 years. The type of income earned by the wealthy also has shifted. In analysis that excludes capital gains, the fraction of income of the one percent that Piketty and Saez call “entrepreneurial” – farm income plus profits from sole proprietorships, partnerships and S-corporations – rose from 7.8 percent of the total in 1981 to approximately 30.9 percent in 2005. (The share has since declined to about 28.6 percent in 2011.) The slice coming from *all* other sources they identify – wages, rent, interest, and dividends – declined over the same period.

The initial rise in “entrepreneurial income” might have resulted from income shifting, Alan Reynolds, a senior fellow at the right-leaning Cato Institute, points out. By reducing the ratio of the top marginal personal income-tax rate to the corporate income-tax rate, the Tax Reform Act of 1986 created an incentive for the wealthy to shift income from corporate tax returns to individual returns.

But, as Professors Piketty and Saez explain, the entire increase in the concentration of income among the top one percent since the 1980s cannot be attributed to this change in tax law alone. Some of the rising concentration of wealth among the one percent likely reflects broader increases in incentives for entrepreneurship over the past 30 years, including government support for innovation and technology commercialization, increased access to capital, and efforts to remove barriers to business formation and growth.

Because "entrepreneurial success is intrinsically lopsided," as Daniel Isenberg pointed out recently, stimulating entrepreneurship means accepting more inequality. Successful entrepreneurs and their investors get rich, in many cases from purchases made by working and middle-class consumers. Unsuccessful business founders lose their savings, homes, and the salaries they could have earned working for someone else.

That's where efforts to improve equality become problematic. Taxing wealth will reduce entrepreneurship by lowering the financial incentive to take risks and because most entrepreneurs use their own savings and family money to finance new business endeavors.

Policy intervention to combat inequality is easier to justify when rising CEO compensation and the wages paid to the Wall Street elite are the cause. When greater entrepreneurship among the well-to-do is responsible, the argument is more difficult to make.

Scott Shane is the A. Malachi Mixon III professor of entrepreneurial studies at Case Western Reserve University. His books include *Illusions of Entrepreneurship: The Costly Myths That Entrepreneurs, Investors, and Policy Makers Live* by (Yale University Press, 2008) and *Finding Fertile Ground: Identifying Extraordinary Opportunities for New Businesses* (Pearson Prentice Hall, 2005).