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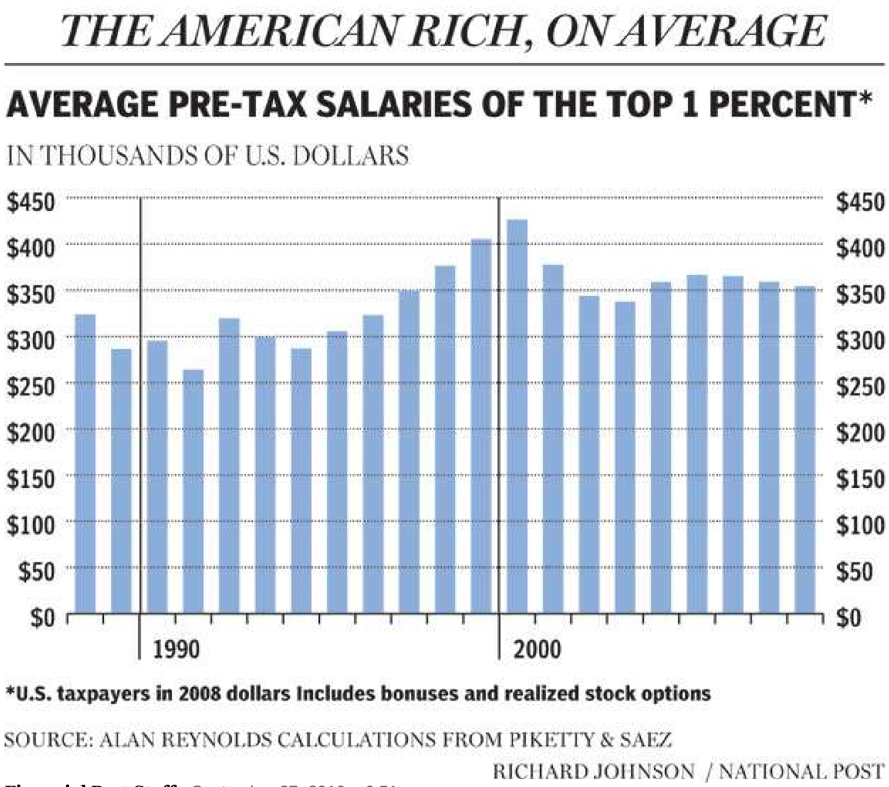
The great inequality debate, part 2: Alan Reynolds



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The real income of the rich has been steady, while U.S. taxation is heavily progressive

By Alan Reynolds

If only tax policy could be so simple: Tax the rich and everybody else gets richer and incomes get equalized. Even more complicated is the underlying assumption of the equality seekers, including Linda McQuaig and Neil Brooks, whose premise is that there is some optimum level of inequality. They seem to like the 1947-73 period when, they claim, the top 10% in the U.S. allegedly earned a relatively steady share of close to 35% the total.

The graph supporting this assertion looks impressive. But as Terence Corcoran pointed out in his original article in this series, it's full of holes. For one thing, it masks the fact that almost all of the increase in income shares of the top 10% can be attributed to the top 1%. Even that doesn't accurately tell a credible story, because the data behind it are faulty.

There is no dispute about the increase in inequality since 1979 — only about whether that increase ended in 1988 or 1993. Nobody doubts the obvious benefits to high-income investors (and to the low-income unemployed) from the rebound in stocks, bonds and the U.S. economy in 1983-89. But what happened since then?

McQuaig and Brooks say there is no debate about these graphic depictions of growing income equality, which are based on the work of Piketty and Saez. But many complex measurement issues concerning income distribution during the past two decades are being questioned.

Aside from my own work, there's Paul Ryscavage's classic study Income Inequality in America and Stephen Rose's new book, Rebound.Other skeptics include Richard Burkhauser at Syracuse University and his associates, Bruce D. Meyer at the University of Chicago and Robert X. Sullivan at the University of Notre Dame, and several others.

There is also no dispute about the high salaries of dozens of top athletes, the top 100 CEOs or 25 hedge fund managers — only about - inequality among the population as a whole. Superstars and top executives account for no more than 4,000 of the 1.4 million - taxpayers in the top 1%.

In a forthcoming paper for the *Cato Journal* I use data from Piketty and Saez to show that most growth of top 1% incomes since the 1986 tax reform has been the result of shifting income from corporate tax forms to individual tax forms (by using Subchapter S corporations, partnerships and LLCs) when individual tax rates fell in 1987 and 2003. There were also unusually large increases in reported capital gains and dividends after those tax rates were cut in 1997 and 2003.

Labour income, including superstars and CEOs, had little to do with changes in top incomes, aside from stock options during the tech-stock boom of 1998-2000. In 2007, the top one percent's share of salaries, bonuses and stock options amounted to 6.29% of all labour compensation, down from 6.87% in 1988.

Furthermore, the average real labour income of the 1.4 million people in the top 1% U.S. income group (aside from capital gains, dividends and business income) went up in 1999-2000, but has otherwise been rather trendless over the past 20 years. (See graph above). Yet labour income (CEO bonuses, superstars, athletes) is all these folks talk about.

As Mr. Corcoran noted, the Piketty and Saez data exclude transfer payments and income that is simply not reported on individual tax returns, often legally (e.g., by being sheltered within a corporation or individual retirement account).

They are not measuring shares of income at all, unless government cheques from, say, Social Security or the earned income tax credit are not income. Government transfers now exceed US$2.3-trillion a year, and account for three-fourths of disposable income among the poorest 20% of U.S. households.

The Piketty-Saez estimates also cover just 10% of "tax units" (students who work part-time are counted as poor "families" even if their parents are affluent), telling us nothing about what has happened to living standards of those with low or middle incomes. They measure pretax income, which only tells us what top incomes would be in a hypothetical world with no government and no taxes.

The OECD study McQuaig and Brooks mention finds "taxation is most progressively distributed in the United States," far more so than Sweden, Canada or France. This makes estimates of pretax inequality irrelevant.

The OECD, responding to me, claims the Piketty-Saez estimates are confirmed by "studies that take into account payments of both personal and corporate taxes," which means the Congressional Budget Office (CBO). The CBO actually adds most corporate taxes to pretax incomes of the top 1%, which is one of many dubious calculations. That bloats top incomes, but does nothing to neutralize the statistical distortion from shifting between corporate and individual tax returns.

McQuaig and Brooks cite CBO estimates from 1979 to 2006, but nearly all of the big gains in top percentile incomes happened before the 1986 tax reform and after the 2003 tax cuts, both of which grossly distort the data. From 1988 to 2003, the CBO estimates that after-tax income of the bottom fifth increased by 14.4%, not greatly below the 22.4% rise for the top 1%.

If the CBO used a more accurate price index, the real income gains at the bottom would have exceeded those at the top (according to Broda, Leibtag and Weinstein's study "The Role of Prices in Measuring the Poor's Living Standards" in the spring 2009 *Journal of Economic Perspectives*).

As shown in my 2007 paper, available at cato.org, CBO estimates are extremely sensitive to what Piketty and Saez (in an article with - Anthony Atkinson of Oxford University) refer to as "the response of reported income to changes in tax law." When tax rates on capital gains were reduced in 1997 and 2003, taxable capital gains reported by the top 1% soared for four years. When the dividend tax was cut to 15% in 2003, dividends reported by the top 1% quintupled in four years.

Numerous studies by Saez and others confirming such powerful responses of reported income to changes in tax rates ("elasticity of taxable income") mean tax-based income statistics are inherently misleading when tax rates change.

If McQuaig and Brooks, Robert Gordon or anyone else believes the Piketty-Saez estimates of pretax incomes of the top 1% can "be addressed through significant tax increases at the upper end," they are making a sophomoric mistake. Higher tax rates or larger transfer payments could not possibly have any direct effect on the Piketty-Saez figures, because those figures explicitly exclude taxes and transfer payments.

The Obama tax measures that Mr. Gordon talks about, however, are not just aimed at the top 1% in the Piketty-Saez universe. They are aimed at the top 2% to 3% — a group that accounts for 25% of U.S. consumer spending. *The Economist* noted that Obama's proposed tax increases on higher incomes next year would cover merely nine days of budget deficits.

After taking into account the ways taxpayers avoid higher levies and the adverse effects on spending and hiring, however, the Obama tax plans would likely yield nothing but pain.

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