Financial Post

Opinion

The myth of inequality

Terence Corcoran, Financial Post · Friday, Sept. 17, 2010

For several years now the American left has been fixated on the idea that the United States has become a divided nation in which an aristocracy of the rich, the super rich and the stinking rich have subjugated the poor, the middle class and everybody else, turning America into the equivalent of some pre-Robespierreian France. This Marxist class war message was embedded in President Barack Obama's first budget: "For the better part of three decades, a disproportionate share of the nation's wealth has been accumulated by the very wealthy."

The basis for that claim and others in the Obama budget is the work of Thomas Piketty and Emmanuel Saez, two economists who in recent years have become the darlings of activists and politicians whose prime aim appears to be to foment class envy and promote new higher tax rates and bigger government. One of their graphs appeared in the Obama budget, apparently showing that the "top 1% of earners have been increasing their share of national income" to the point where the stinking rich 1% earn 20% of the total, double their share from 10% in 1980.

Other Piketty-Saez graphs, variation on the same theme, often make their way into the media, including the National Post. On the editorial pages of the Post last Wednesday, one of their iconic illustrations was used to support an op-ed by journalist Timothy Noah and his theme that America had become the United States of Inequality. The graph, reproduced above, appears to prove that income disparity is growing in the United States, with the top 10% of income earners taking up almost 50% of national income, up from 35% in 1980.

Mr. Noah's op-ed (The Great Divergence, Sept. 15) was first published by Slate as part of a series in which Mr. Noah weaves a tangled Wikipedian web of quotations, citations and statistics around the graph to prove that the level of inequality and disparity today in the United States is historical. It takes the country back to the early 20th century, a time when "the socialist movement was at its historic peak, a wave of anarchist bombings was terrorizing the nation's industrialists." In American history, says Mr. Noah, "there has never been a time when class warfare seemed more imminent."

The obvious implication of Mr. Noah's op-ed is that the U.S. has reverted back to some barbarian time -- if only the people knew it. "Growing income inequality is deeply worrying," said Mr. Noah. It "may represent the most significant change in American society in your lifetime -- and its not a change for the better."

Unfortunately for Mr. Noah, as he laments frequently, the American public doesn't quite buy the Piketty/Saez inequality scare. Nor do many economists outside of the Paul Krugman circle Mr. Noah seems to be traveling in. The Tea Party movement seems to be more concerned about taxes on the middle class than the rise of inequality.

The graph itself reeks of implausibility -- the huge dip during the Second World War, the flat-line through the 1940s to 1970s, and the sudden escalation over the last 30 years. For one thing, it measures pretax market income, excludes government transfers, and includes capital gains. Pretax income levels are essentially meaningless in an economy where massive tax redistributions alter the final outcome. Excluding government transfers --social security, welfare, medicare, unemployment and other benefits -- means that lower income levels are grossly understated, especially since such transfers surged through the welfare-state expansions of the middle of the 20th century.

The inclusion of capital gains and other business income also creates a distortion. It is also impossible to compare income levels over a century when massive changes in tax regimes radically shifted income reporting and strategies.

How badly does this Piketty/Saez graph distort the picture? How far are these numbers from the reality of income distribution across the United States? And, as a result, how far away is America from Mr. Noah's implied return to a new state of class warfare and, perhaps, the rise of some modern-day Marxist extremist movement?

The economic literature is full of debate, most of it in rejection of the basic premise that inequality has been dramatically on the rise. Prof. Robert J. Gordon of Northwestern University, in a 2009 paper (Has the Rise in American Inequality Been Exaggerated?) found contrary evidence throughout the literature. He also conducted his own review of income inequality arguments to support his conclusion that the inequality gap is grossly exaggerated. Making adjustments to more conventional measures -- median household income vs productivity -- Prof. Gordon found that "over the three decades [from 1979 to 2007] the alternative gap measure grew at an annual rate barely one-10th as fast as the conventional gap measure."

When incomes of taxpayers are adjusted for regional cost of living differences, the finding is that inequality --such as it was--stopped growing more than 15 years ago.

The Piketty-Saez graph also contains another distortion. All of the increase in pretax income of the top 10% share can be attributed to the top 1% of income earners. Thanks in part to tax rules and to a burgeoning economy that pushed financial, entertainment and sports industry salaries to new highs, only the top portion of the income ladder recorded huge gains in pretax income. The tax-induced and regulation-promoted use of stock options also boosted the incomes of the top 1%. But the incomes of the group immediately below the top 1% -- the other nine percentage points of top income earners -- did not increase their share of incomes over the same period. Between 1927 and 2006, Prof. Gordon shows their share to be flat -- despite tax law changes that encouraged stock options.

But again, these are pretax calculations. Alan Reynolds, of the Cato Institute, says the whole Piketty-Saez methodology is flawed and useless. Based on his calculations, using disposable after-tax income as a basis and including transfers from government, there has been no change in U.S. income inequality over the last decades.

Based on disposal income (after tax, after transfers), Mr. Reynolds says there has been no increase in inequality since 1987. "Aside from stock-market windfalls ... there is little evidence of a significant or sustained increase in the inequality of U.S. incomes, wages, consumption or wealth over the last 20 years." With the stock-market crash of 2008 and reversals in other markets, any recent blips in inequality measures will have been wiped out by now.

As for the period prior to 1980, Mr. Reynolds says no real comparisons can be made since major changes in tax laws in 1986 and 1993 created radical changes in incentives that promoted stock options and income-shifting behaviour.

Even though the Piketty-Saez version of income inequality history may be shaky, it is being used explicitly to promote higher taxes on the rich. The two economists, in a paper last October, said the inequality indicators suggest there is great new "tax capacity" among the rich. Increased taxes on the top income group "would yield appreciable revenue that could be deployed to fund public goods and redistribution."

Tax the rich, keep taxes high, don't cut taxes: that's the underlying message from the whole exercise-- from Mr. Noah to Professors Piketty and Saez to Barack Obama. The United States is slipping into a state of gross income inequality, worse than most other countries. Time for a regime change that will punish the rich and reward the poor.

Meanwhile, the OECD has described the U.S. tax system as one of the most equitable. The United States, it said in a 2008 report, "has the most progressive tax system and collects the largest share of taxes from the richest 10% of the population." (See table at left.) Even if America has more rich than other nations, it does more to redistribute than others. There's more to redistribute.

Which leads is to other subjects. Why, for example, does inequality of incomes -- before or after tax -- --even matter in a market economy where no kings rule by force and no aristocracy plunders the people?

Tomorrow: Peter Foster on the psychological and historical roots of the liberal obsession with income inequality.