Piketty Ignores Changes in the Tax Rules

Thomas Piketty's Capital in The Twenty First Century, has spawned a cottage industry of dissent. Piketty uses masses of data to illuminate a growth in inequality, that he surmises is an inevitable result of capitalism and can only be resolved by painfully high taxes on the rich. For the left it is a pivotal work that brings data and credentialism to their ideology that capitalism is so flawed that it requires constant and strong control from the state.

Anti-Piketty is a collection of noted economists and political thinkers that find significant flaws with Piketty's work. These critiques include serious flaws with the data itself and how it is used, the difficulty of measuring the forms of income and inequality itself, conclusions that are not supported by the data, and a philosophically flawed concept of wealth, growth and capitalism.

From Anti- Piketty Chapter 9. Piketty's Numbers Don't Add Up by Martin Feldstein

> *The second problem with 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 percent 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.*
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> *In 1981 the top tax rate on interest, dividends, and other*

investment income was reduced to 50 percent from 70 percent, 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 percent from 50 percent. That change 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. The corporate income of professionals and small businesses did not appear in the income-tax data that 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 that 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.