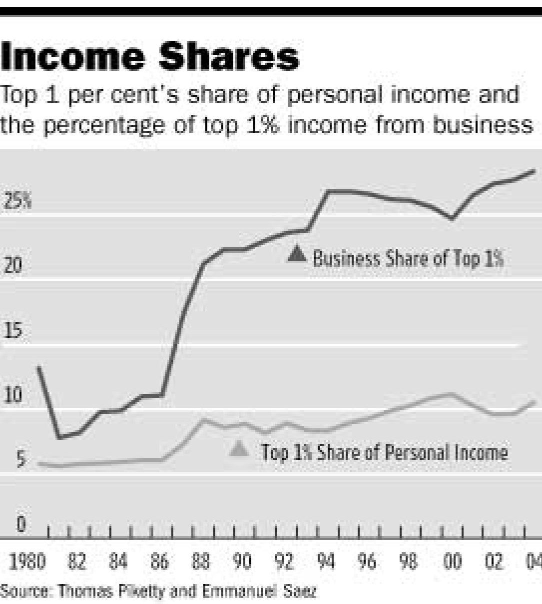
The Top 1% . . . of What? by Alan Reynolds, Wall Street J. 12/17/06

As many others have done, Virginia's Democratic Senator-elect Jim Webb recently complained in The Wall Street Journal (article available here) 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 The Journal. 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).

Tax Cuts and the Rich by Alan Reynolds, Cato Institute Policy Analysis 1/8/07

The New York Times headline — "Tax Cuts Offer Most for Very Rich" — said it all. That claim was uncritically repeated by CNN, posted on Brad DeLong's blog and so on. But was it true?

The report by Edmund Andrews was about the latest "Historical Effective Tax Rates" from the Congressional Budget Office (CBO).

The CBO shows that from 2000 (the year before Bush cut tax rates) to 2004, the after-tax income of the very richest 1 percent fell by 7.9 percent. After taking into account the Bush tax cuts, the 8.3 percent drop in after-tax incomes of the top 1 percent was even worse. From 2000 to 2004, average real incomes of the middle three-fifths rose 4.1 percent after-taxes, but only 0.5 percent before taxes. In other words, 88 percent of middle-income gains between 2000 and 2004 were due to those nefarious Bush tax cuts of 2003.

Those who rely on The New York Times (unlike readers of The Washington Times), will never find out what the CBO report reveals unless they go to cbo.gov and read it for themselves. To have any chance of having his story to appear in The New York Times, Andrews had no choice but to dissemble.

He began by saying, "Families earning more than $1 million a year saw their federal tax rates drop more sharply than any group in the country as a result of President Bush's tax cuts, according to a new congressional study." But the top 1 percent of households (not families) are those earning more than $266,800 — not more than $1 million. The average income for everyone earning more than $266,800 exceeds $1 million, but such a mean average is bloated by a small number of very high incomes, particularly distributed earnings of Subchapter S-corporations.

This is why we use median income to describe typical income in other cases, and should also do so when describing average income of top income groups (which differ from lower groups because income has no upper limit).

Andrews continued, "Though tax cuts for the rich were bigger than those for other groups, the wealthiest families paid a bigger share of total taxes. That is because their incomes have climbed far more rapidly, and the gap between rich and poor has widened in the last several years."

Unless "last several years" excludes 2000, the statement is brazenly false. It makes no sense to start with any year except 2000 because we can't possibly compare incomes and taxes before and after the Bush tax cuts unless we begin with the last year of the Clinton presidency. That is, after all, the tax regime congressional Democrats set up as their ideal when they criticize the Bush tax changes as unduly generous to the top 1 percent.

Measured in constant 2004 dollars, average income of the top 1 percent was $1,413,000 in 2000, but only $1,259,700 in 2004 — a drop of 7.9 percent. Tax cuts did not help a bit. After-tax income of the top 1 percent fell from $946,300 to $887,800 — an even larger 8.3 percent decline.

Andrews says, "Economists and tax analysts have long known that the biggest dollar value of Mr. Bush's tax cuts goes to people at the very top income levels." You don't need to be an economist to discern that "the biggest dollar value" of any equiproportionate tax cut must go to those with the "biggest dollar value" of taxes paid. Yet the top 1 percent did not get anything remotely close to a proportionate share of the tax cuts after 2000.

The article says "the wealthiest families paid a bigger share of total taxes," but what is remarkable is that they even paid a larger share than they did in 2000, although their before-tax incomes were 7.2 percent smaller. That explains why the top 1 percent's after-tax income fell even more than their before-tax income. The top 1 percent ended up with 14 percent of after-tax income, down from 15.5 percent in 2000, and that includes one-time capital gains and a seriously exaggerated share of corporate profits.

Andrews added that "two of (the president's) signature measures, tax cuts on investment income and a steady reduction of estate taxes, overwhelmingly benefit the wealthiest households."

That sentence is half irrelevant, half mistaken.

The CBO does not attempt to assign the estate tax by income group. To do that they would have to know who received the money, not who died. Dead people cannot receive more income, before or after taxes, which is just one reason why death is a highly undesirable tax avoidance strategy. If Hugh Jassets dies and leaves $10 million to be split among 10 young grandchildren, those youngsters are likely to be either invisible or poor in terms of income showing up in CBO tax data.

Second, taxes on capital gains and dividends are surprisingly hard on older retirees with low incomes. Those with incomes below $15,000 paid over 7 percent of the federal taxes on dividends in 2002, and those with incomes below $200,000 paid 62 percent of that tax.

Third, lower tax rates on taxable dividends and capital gains generally result in investors paying more taxes on their investment income, not less. Nobody has to hold dividend-paying stock in a taxable account, and nobody has to report capital gains by selling assets from a taxable account. The amount of dividend income reported to the IRS doubled from 2002 to 2004. Upper-income taxpayers are bound to be reporting relatively less income from tax-exempt bonds than they did before 2003. Moving income from nontaxable to taxable investments looks like an increase in top incomes in the CBO estimates, but it isn't.

There has been a lot of chatter lately about raising Social Security taxes only on those with incomes above $100,000 while also cutting that same group's Social Security benefits again (their benefits were deeply slashed in 1993 through an extra tax on benefits). Can anyone really pretend that sounds "fair"?

The CBO calculates the effective tax rate for all federal taxes — including Social Security and Medicare taxes, income taxes and excise taxes. For the bottom 80 percent as a group, that total federal tax fell from 14.1 percent in 2000 to 11.4 percent in 2004 — a 19.1 percent tax cut. The tax cut was deepest among the poorest fifth (29.7 percent), largely because of the Bush administration's refundable tax credit for children. For the middle fifth, the total tax rate fell from 16.6 percent to 13.9 percent — a 16.3 percent cut. As for the top 1 percent, their overall tax rate was merely trimmed from 33 percent to 31.1 percent — a 5.8 percent cut

A truly courageous (willing to be fired) ombudsman of The New York Times would insist on the following correction to Andrews' upside-down article:

"Households earning more than $266,800 a year saw their federal tax rates drop less sharply than any other group in the country as a result of President Bush's tax cuts, according to a new Congressional Budget Office study."

Alan Reynolds is a senior fellow with the Cato Institute.