

**PIKETTY'S INEQUALITY CONCLUSIONS INACCURATE,  
RECOMMENDATIONS IMPOSSIBLE**

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**by**

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## **PIKETTY'S INEQUALITY CONCLUSIONS INACCURATE, RECOMMENDATIONS IMPOSSIBLE**

In his calculations of inequality in *Capital in the Twenty-First Century*,<sup>1</sup> Professor Thomas Piketty of the Paris School of Economics ignores the state-of-the art evidence on economic inequality, exaggerating its growth. Furthermore, even if Piketty's measurement of inequality were accurate, his policy recommendation, a global wealth tax, would not sustain capitalism nor help low-income individuals. Yet his book is being touted as evidence for the need to increase taxes.

Piketty's basic thesis is that when the rate of return on capital is greater than the rate of growth of GDP, inequality increases. To solve growing inequality, which Piketty believes is unsustainable and will lead to the end of capitalism, the government has to increase taxes on capital, or wealth.

Even if Piketty has proved increased inequality—and I suggest below that his conclusions are exaggerated—it does not follow that the solution is to tax capital. Piketty writes in his introduction, “I use the words “capital” and “wealth” interchangeably, as if they were perfectly synonymous.”<sup>2</sup> Tax professionals know that capital and wealth are not interchangeable, and that taxing capital and taxing wealth are two very different types of taxation.

Wealth consists of aggregate assets, including houses, boats, cars, jewelry, real estate, and the value of financial assets. It is difficult to measure, and to tax, because it is constantly changing value. The Federal Reserve's Survey of Consumer Finances attempts

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<sup>1</sup> Thomas Piketty, *Capital in the Twenty-First Century*, The Belknap Press of Harvard University, 2013.

<sup>2</sup> *Ibid*, page 47.

to measure wealth every three years, but many people do not reveal the value of their assets to the Fed, so accuracy of the survey is unclear.

Some might define the assets above as capital, and some might not. What is certain is that capital also includes plant and equipment, intellectual property, and reputational value. The problem of taxing these assets is different from the problem of taxing wealth. Taxes often affect plant, equipment, and other assets of the firm that have nothing to do with concepts of consumer wealth discussed above. For tax purposes, there are specific taxes on capital that vary by industry. Some assets, such as reputational value and intellectual property, are amortized rather than depreciated.

Another problem with Piketty's thesis is that there is no one rate of return on capital. Trillions of dollars are being cycled through the federal government at likely negative real interest rates. But private sector returns on equity were very high over the past year. What was the rate of return on capital?

When people look at the risk-free return on capital, they look at federal government paper, such as government bonds or Treasury bills. For many on fixed incomes, however, these assets do not provide adequate return, so they purchase riskier assets in the stock market.

A vast economic literature shows that taxing capital slows economic growth rather than increases it.<sup>3</sup> Slower economic growth provides fewer returns for everyone, and fewer job opportunities for everyone.

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<sup>3</sup> See, for example, William Gentry and Glenn Hubbard. "Success Taxes,' Entrepreneurial Entry, and Innovation." 2005. Jon Gruber and Emmanuel Saez. "The Elasticity of Taxable Income : Evidence and Implications." Journal of Public Economics. 2002. Edward Prescott, Edward C. "Why Do Americans Work So Much More Than Europeans?" Federal Reserve Bank of Minneapolis. 2003. Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey S. Rosen. "Entrepreneurs, Income Taxes and Investment." National Bureau of Economic Research. 1998.

In addition, most Americans over their life cycles will own some form of capital in pension and retirement accounts. State and local pensions, which benefit state employees from teachers to firefighters to trash collectors, have \$4.5 trillion in liability, according to an annual report published earlier this year by State Budget Solutions.<sup>4</sup> Taxing capital will lower the returns on these funds, requiring an increase in other forms of taxation. In addition, Americans in a wide variety of income levels own \$6.5 trillion in individual retirement accounts and \$4.2 trillion in 401(k) accounts.<sup>5</sup>

The *raison d'être* of Piketty's tax proposals is that inequality has been increasing. Piketty presents data from his extensive prior research, coauthored with Emanuel Saez, to show that inequality in the United States has grown from the 1970s to the present.<sup>6</sup> But this research has a number of methodological drawbacks previously addressed in the academic literature by Cato Institute senior fellow Alan Reynolds and others.<sup>7</sup>

First, the Tax Reform Act of 1986 resulted in a movement of income away from corporate tax returns and on to individual income tax returns beginning in 1987, because the top individual rate of 28 percent was lower than the top corporate rate of 35 percent. Prior to 1987, the top individual rate was 50 percent, making it advantageous to file as a corporation. An examination of individual incomes show a jump in income after 1987—but these data are not truly comparable with data from prior years.

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Kyle Pomerleau, "The High Burden of State and Federal Capital Gains Tax Rates," Tax Foundation, February 2014.

<sup>4</sup> Cory Eucalitto, "Annual State Debt Report," State Budget Solutions, January 2014.

<sup>5</sup> Investment Company Institute, "The U.S. Retirement Market, Fourth Quarter 2013," March 26, 2014.

<sup>6</sup> Thomas Piketty and Emmanuel Saez, "Income Inequality in the United States, 1913-1998," *Quarterly Journal of Economics*, 118:1, 2003, pages 1-39 (data updated in September 2013).

<sup>7</sup> Alan Reynolds, *Income and Wealth*, Greenwood Guides to Business and Economics, 2006.

Second, Piketty measures income before taxes are subtracted and transfers are added. Pre-tax, pre-transfer measures of income are not realistic measures of inequality.<sup>8</sup>

The top one percent paid 35 percent of all federal individual income taxes in 2011, and the top half of earners paid 97 percent. The bottom half of earners paid 3 percent, and received back a share of the 97 percent paid by the top half for programs including Medicaid, food stamps, the earned income tax credit, housing vouchers, and unemployment insurance.

Well-respected academic economists such University of Chicago professor Bruce Meyer and University of Notre Dame professor James Sullivan<sup>9</sup> have included taxes paid and transfers received and computed measures of inequality of consumption, a more realistic guide to well-being. Cornell University professor Richard Burkhauser also includes the effects of capital gains and examines households, not tax units. They concluded that consumption inequality has not increased and that poverty, while not cured, is declining.<sup>10</sup> Neither Meyer, Sullivan, nor Burkhauser are mentioned in the lengthy book.

Third, Piketty does not account for the movement of women into the workforce during the 1980s. It became increasingly common for mothers with children to work outside the home in the 1980s. In 2012, in the top fifth of the income distribution, households average two earners per family. In the middle quintile, households have about

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<sup>8</sup> Diana Furchtgott-Roth, "Measuring Income Inequality," *Tax Notes*, March 5, 2012, page 1307.

<sup>9</sup> Bruce Meyer and James Sullivan, "Winning the War: Poverty from the Great Society to the Great Recession," *Brooking Papers on Economic Activity*, Fall 2012.

<sup>10</sup> "Philip Armour, Richard V. Burkhauser, and Jeff Larrimore, "Levels and Trends in United States Income and Its Distribution A Crosswalk from Market Income Towards a Comprehensive Haig-Simons Income Approach," National Bureau of Economic Research working paper, June 2013.

one earner per household. In the lowest fifth, there is one earner for every two households, with retirees and unemployed.<sup>11</sup>

This has changed demographic characteristics of households since the 1980s, the period Piketty cites as showing increased inequality.

Fourth, the size of households has changed since 1980. Due to the increased prevalence of divorce and longer life expectancy, there are more households composed of one person, or non-family households. These households tend to be in the lower quintile.<sup>12</sup> This contributes to perceived inequality. On average, households in the bottom quintile have 1.7 members, and those in the top quintile have 3.1 members.

Fifth, people move around the income distribution during their life cycle. Piketty takes little account of this mobility. Piketty's view of economic mobility focuses on the top one percent, and ignores mobility between quintiles. To Piketty, Americans do not have economic mobility because very few employees of McDonald's, General Motors, or Ford will reach the top one percent.

Specifically, Piketty writes that "if each individual were to enjoy a very high income for part of his or her life (for example, if each individual spent a year in the upper centile of the income hierarchy) then an increase in the level characterized as "very high pay" would not necessarily imply that inequality with respect to labor—measured over a lifetime—had truly increased."<sup>13</sup> He complains that "workers at McDonald's or in

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<sup>11</sup> U.S. Department of Labor, Bureau of Labor Statistics, Consumer Expenditure Survey, September 2013.

<sup>12</sup> U.S. Census Bureau, Current Population Survey, Annual Social and Economic Supplements, 2013.

<sup>13</sup> Thomas Piketty, *Capital in the Twenty-First Century*, The Belknap Press of Harvard University, 2013, page 305.

Detroit's auto plants do not spend a year of their lives as top managers of large US firms."<sup>14</sup>

Mobility is not only defined as moving to the top one percent, it is also defined as moving up a few quintiles. Many are satisfied moving a few quintiles, an achievement that can result in doubling their incomes over their lifetimes. According to [a paper](#) by U.S. Treasury Department economists Gerald Auten, Geoffrey Gee, and Nicholas Turner, many move from the bottom to middle quintiles or to the top quintile, and also move in the other direction.<sup>15</sup> It is a substantial omission from the book that Piketty does not mention the work of Auten and his coauthors.

Although Piketty is focusing on the top one percent, he neglects to mention [Treasury data](#) that show substantial movement among the top 400 adjusted gross income earners. That of the 3,869 people who appeared in the Top 400 U.S. taxpayers by adjusted gross income over the period 1992 to 2009, only 87 people appeared there for 10 or more years. Contrary to what Piketty describes, the top one percent are not static.

One look at the GDP growth rate for the first quarter, negative 2.4 percent, illustrates the absurdity of Piketty's prescription for solving equality. Some assets have a greater return than negative 2.4 percent—does that mean that Congress wants to raise taxes on those assets? That would mean that publically-owned and privately-owned firms would cut back on capital investments. This would hurt, rather than help, Americans looking for jobs.

Not only are Professor Piketty's tax proposals ambiguous and unworkable, but his analysis of inequality in America ignores relevant data and previously-published

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<sup>14</sup> *Ibid*, page 300.

<sup>15</sup> Gerald Auten, Geoffrey Gee, and Nicholas Turner, "Income Inequality, Mobility and Turnover at the Top in the U.S., 1987-2010," *American Economic Review*, 2013.

research. Those who use *Capital in the Twenty-First Century* as an excuse to lobby for higher taxes should read the book more carefully.