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Piketty's Botched Analysis of Inequality in India

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Three years ago, French economist Thomas Piketty wrote the bestseller *Capital in the 21st Century*.[1] He argued that capitalist economies have a natural tendency to concentrate wealth in the hands of the few.

Recently, Piketty and Lucas Chancel produced a new working paper, "Indian Income Inequality, 1922–2014: From British Raj to Billionaire Raj?"[2] They suggest that inequality in India is the highest since 1922, when income tax was introduced, and that the richest 1 percent of Indians receive 22 percent of all income. They estimate that inequality rose from 1922 to 1939–1940, and then declined sharply from Independence in 1947 to the early 1980s. This was a socialist era marked by very high tax rates, mass nationalization, and pervasive industrial and trade controls. Inequality, say Piketty and Chancel, rose after the mid-1980s and accelerated in the era of economic liberalization that started in 1991, gathering momentum in the 2000s.

There are two main problems with this analysis. One is its statistical flaws. The second is its failure to distinguish between different types of equality and inequality. These shortcomings lead Piketty to imply that the socialist era, but not the era of liberalization, was excellent for the common man. That is simply wrong.

PROBLEMS WITH THE DATA

The paper constructs a complex model combining three types of data—consumption data from surveys conducted by the National Sample Survey Organization (NSSO) and India Human Development Survey (IHDS); GDP data; and income tax data. Piketty admits that this mishmash of data sources is "fraught with methodological and conceptual difficulties."[3] So he attempts to buttress this with a series of alternative assumptions. But the problem of "rubbish in, rubbish out" remains: the alternative assumptions use the same mix of three data sources, with the same statistical infirmities.

Inequality is measured by the Gini coefficient, ranging from zero for total equality to 1 for total inequality. Consumption surveys of the NSSO show a modest Gini increase from 0.3 in 1983 to 0.36 in 2011–2012.[4] The IHDS surveys show the consumption Gini rising marginally from 0.38 in 2004–2005 to 0.39 in 2011–2012. The IHDS also estimates incomes, for which the Gini has risen from 0.53 to 0.54. This again is a marginal change, in contrast with Piketty's thesis of runaway inequality.[5]

Piketty rejects these survey data. Consumption as reported in NSSO surveys has started differing widely from consumption as measured in GDP data. The ratio of consumption in the surveys to consumption in GDP data has fallen steadily

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from 87 percent in 1972–1973 to barely 40 percent in 2011–2012. Of the many possible explanations, Piketty emphasizes the thesis that the rich increasingly hide their consumption from surveyors for fear of tax consequences. The nonrich, he says, have no such compulsion. Hence he uses a mix of NSSO and IHDS data to estimate the incomes of the bottom 95 percent of people since 1950, but uses income tax data for the richest 5 percent.[6] This double standard produces a dramatic increase in estimated inequality.

A minute's thought will expose the absurdity of this double standard. Piketty thinks the rich lie to NSSO surveyors, and so he switches to income tax returns for the rich alone. Incredibly, he thinks the rich tell the truth to the taxman, but lie to surveyors! Why should the rich be more truthful to the taxman, when the consequences are far worse?

Piketty's assumption that the nonrich tell the truth to surveyors is also dubious. Consider the fate of exit polls in Indian elections, on which political parties and TV channels spend large sums to try to get accurate predictions. In practice, exit polls vary widely from one surveyor to another, and from the actual outcome. Why? Because, as one voter told pollsters, "Why should I tell you truthfully? What will I get out of it?"[7]

Economist Devesh Kapur once conducted a survey of Dalits (once called "untouchables"), using a local facilitator. A Dalit being surveyed said he was in very bad shape. Then, by coincidence, it came to light that there was a marriage proposal between the families of the Dalit and the facilitator. The Dalit immediately declared that he had been lying, and was actually very well off! Clearly the nonrich will lie if it benefits them.[8]

I once asked an activist who had worked in rural Rajasthan state whether villagers would tell the truth about their incomes. He said a villager might well exaggerate his income when talking to fellow villagers, to boost his local image. But when talking to outsiders, the villager would probably understate his income, just in case this might qualify him for a handout or subsidy from the government or a charity.[9]

Once, most subsidies in India were universal. But in recent decades, the central government has targeted those below the poverty line, who get much cheaper food grains, kerosene, and housing. State governments have additional targeted schemes. So, villagers have strong incentives to understate their income to surveyors to maximize benefits. This is an important reason why consumption as measured by surveys keeps falling compared to consumption measured by GDP.[10]

Even as the incentives of the nonrich to lie have increased, the incentives of the rich to lie have fallen. The top income tax rate has fallen from 97.75 percent in 1970 to 70 percent in the early 1980s down to 30 percent in 1997 (it has just been raised again to 35 percent). Long-term capital gains became tax-free in 2004, and dividends became tax-free for individuals after 2003. So the incentives for the rich to conceal their riches have fallen dramatically over time.[11] This dents—perhaps destroys—Piketty's modeling, which assumes that the rich lie to surveyors but the nonrich don't.

THE FLAWS OF INCOME TAX DATA

Piketty also ignores huge technical problems that arise when tax data are used to measure inequality. Tax data both understate and overstate inequality, mostly the latter.

Household surveys cover only humans. However, tax laws cover artificial entities such as corporations and trusts. If a businessperson owns 60 percent of a large company, the owner's tax returns don't include a 60 percent share of company profits; they include only dividends declared by the company, which may be zero. Again, the owner may control several trusts. So, a business owner can arrange his or her affairs to show virtually no personal income. This was indeed the strategy used by the rich when Indira Gandhi raised the top income tax rate to 97.75 percent. Piketty's calculations based on tax data show a huge fall in inequality in the socialist 1970s, but this is, in part, illusory. Faced with confiscatory tax rates, the rich kept most income as undistributed corporate profits or black money. This greatly exaggerated the decline in their declared incomes, and in inequality as measured by Piketty.

In other ways, tax data grossly exaggerated inequality. Surveys by the NSSO or IHDS estimate the consumption or income of households, divide this by the number of family members, and get a per capita figure. But income tax data in India relate strictly to individuals, and tell you nothing about family income. If a rich man has a wife and kids attending college who earn nothing, the wife and kids will show up in tax data as paupers, even if they own Mercedes cars and go to London for weekend shopping. By not dividing family income among members, tax data grossly exaggerate the living standard of the businessman and grossly underestimate that of his wife and children. This methodology produces a huge but artificial inequality.

Piketty should group all family income and divide it by the number of family members, as in NSSO and IHDS surveys. By using divided data for the nonrich but not the rich, Piketty greatly inflates the gap between them.

He estimates that the richest 1 percent have 22 percent of all income. He doesn't say what the share of the richest 5 percent was, but let's conservatively take it to be 2.5 times as much, or 55 percent. If these people were taxed at the top rate

of 35 percent, this should have yielded tax revenue of around 20 percent of GDP. In fact, the total income tax revenue is under 2 percent of GDP.

Where has the rest gone? In tax exemptions. Most exemptions (e.g., long-term savings or provident-fund contributions) are trivial for the rich. A bigger exemption is for donations to charitable trusts, but this is limited to 10 percent of gross income. The most important tax break, by far, is for capital gains. Long-term capital gains became tax-free in 2004 for sales through stock exchanges. This induced a great deal of selling and buying, creating massive capital gains at a time of soaring stock markets.[12]

All capital gains (including exempt ones) are included in tax returns. The taxman defines capital gains as income. But GDP, as defined in economics, excludes capital gains, since they don't reflect value addition: they merely reflect the churning of assets. Consider two rich men with equal portfolios. One does not churn his portfolio at all, while the second does so every month. At the end of the year, the two portfolios may have the same value. But the first portfolio will show zero capital gains while the second will show huge gains. This creates the illusion of a huge gap, although there is none. Many investment gurus now say that an unchurned portfolio will do as well as, or better, than a churned one, so there is no income advantage in churning. Yet the taxman treats churning as massive income. GDP calculations do not, and they represent reality far better.[13]

GOOD AND BAD SORTS OF INEQUALITY

Finally, Piketty fails to distinguish between different sorts of inequality and their very different implications for fairness. He says the income share of the top 1 percent fell sharply to 6 percent under Nehru-Indira socialism from 1950 to the mid-1980s, and then rose sharply, especially in the era of economic liberalization after 1991. This implies that ordinary folk were treated better in the socialist era than the liberalization era. Dead wrong. The poverty ratio did not fall at all between 1947 and 1977, while the population almost doubled. So, the absolute number of poor almost doubled.[14]

By contrast, fast growth induced by economic liberalization raised 138 million people above the poverty line between 2004 and 2011. Doubtless, inequality must have increased after economic liberalization, although not as much as Piketty estimates. After all, entrepreneurs who had been bound hand-and-foot during the socialist era were now able to soar and globalize. Indian GDP growth averaged 8 percent in the 2000s, and this rising tide lifted all boats. Inegalitarian liberalization proved far better for the poor than egalitarian socialism. Liberalization provided new opportunities, which mattered more than equality. All rural areas have much lower Ginis (hence more equality) than urban areas, yet all migration is from villages to towns. People vote with their feet for opportunity over equality. The rural Gini (0.17) is lowest in the states of Bihar and Assam, but these are Sloughs of Despond and stagnation, not egalitarian paradises.[15] Biharis migrate in the millions to richer, but more unequal, states for work. The second-highest rural inequality (0.29) is found in Kerala, India's most socially advanced state, which has the lowest rates of infant mortality and illiteracy and the highest wage rate. Kerala has gained hugely through globalization—it sends the most migrant workers to the Gulf, and benefits from their remittances. This creates inequality, but its living conditions are far better than in the more egalitarian Bihar or Assam.[16]

Dalits, once called "untouchables," are at the very bottom of India's caste system. Economic liberalization, by generating new business opportunities, has created 3,000 Dalit millionaires. This will show in Piketty's data as worsening inequality. But this sort of inequality merits celebration. India needs more social mobility and rags-to-riches stories.[17]

In sum, some types of equality can be terrible (stagnation in rural Bihar, rising numbers of poor in the socialist era), while some types of inequality can be good (the rise of Dalit millionaires, the slashing of poverty in the roaring 2000s).

India's greatest curse is inequality of opportunity. People with skills and access to global markets have benefited hugely, while those in rural areas without skills or connectivity have lagged far behind. Piketty does not address this massive inequality of opportunity. Soaking the rich is not the answer, as shown by the failed socialist era. India needs a decent school, health center, road, electricity supply, and broadband data transmission in every village. It needs uncorrupt, accountable, and skilled government staff. Economic liberalization has achieved much, but it should now be supplemented by high-quality public goods.[18]

NOTES

1. Thomas Piketty, *Capital in the Twenty-first Century* (Cambridge, MA: Belknap Press, 2014).

2. Lucas Chancel and Thomas Piketty, "Indian Income Inequality, 1922–2014: From British Raj to Billionaire Raj?" Word Wealth and Income Database, WID.world Working Paper Series no. 2017/11 July 2017.

3. Ibid., p.4.

4. Himanshu, "Inequality in India," *Seminar* (New Delhi), August 2015.

5. Sonalde Desai, principal investigator, India Human Development Survey. Email to the author, September 2017.

6. Chancel and Piketty take the ratio of consumption to income in the IHDS surveys of 2004–2005 and 2011–2012 and apply these to consumption surveys of NSSO since the 1950s to estimate incomes of different deciles. Sonalde Desai objects to this, saying the structure of the workforce has become much less agrarian in the 2000s, so applying the ratio of this era to earlier, highly agrarian decades is misleading. Desai, email to the author, September 2017.

7. Prannoy Roy, head of New Delhi TV. Personal conversation with the author.

8. Devesh Kapur, Chandra Bhan Prasad, Lant Pritchett, and D. Shyam Babu, "Rethinking Inequality: Dalits in Uttar Pradesh in the Market Reform Era," *Economic and Political Weekly*, August 28, 2010.

9. Vivek Ramkumar, formerly a worker for the Mazdoor Kisan Shakti Sangathan (a nongovernmental organization working for civil rights and the rights of workers and farmers), in the state of Rajasthan. Private conversation with the author.

10. Swaminathan S. Anklesaria Aiyar, "Why the Poor Want to Stay Very Poor on Paper," *Times of India (*New Delhi), May 1, 2011.

11. Ibid.

12. Swaminathan S. Anklesaria Aiyar, "A Purple Passage to India," *Economic Times* (New Delhi), October 11, 2017.

13. Ibid.

14. Swaminathan Aiyar, "Why Thomas Piketty is Wrong about Inequality in India," *Financial Times*, September 28, 2017.

15. John Bunyan, *The Pilgrim's Progress* (London: Nathaniel Ponder, 1678). In this book the Slough of Despond is a deep bog from which escape is difficult.

16. Aiyar, "Why Thomas Piketty is Wrong about Inequality in India."

17. Devesh Kapur, Chandra Bhan Prasad, and D. Shyam Babu, *Defying the Odds: The Rise of Dalit Entrepreneurs* (New Delhi: Random House India, 2014); and Swaminathan S. Anklesaria Aiyar, *Capitalism's Assault on the Indian Caste System: How Economic Liberalization Spawned Low-Caste Dalit Millionaires*, Cato Institute Policy Analysis no. 776, July 21, 2015.

18. Aiyar, "Why Thomas Piketty Is Wrong about Inequality in India."