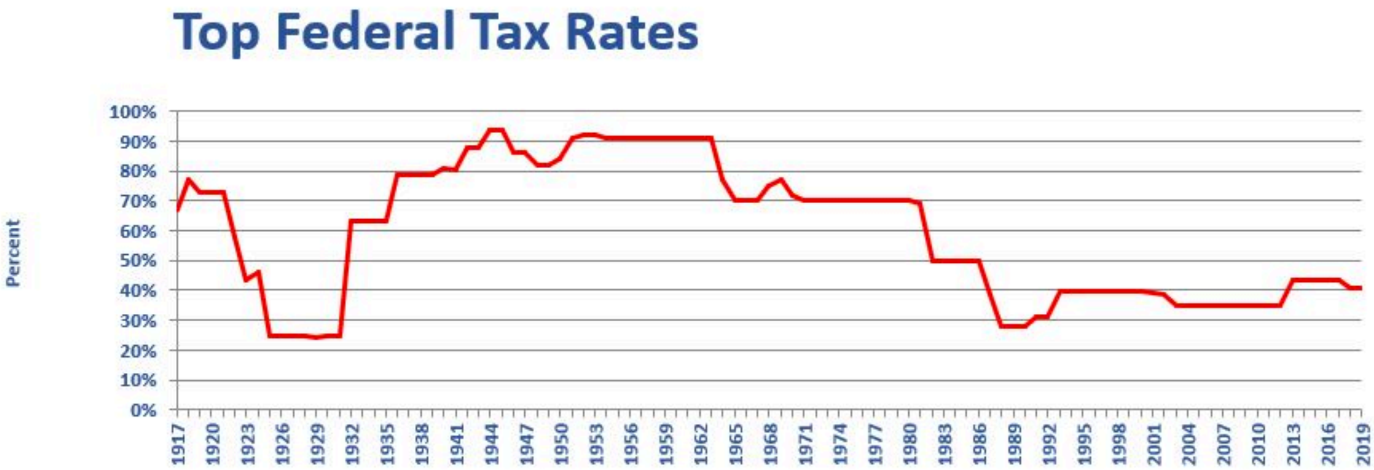
Implications of Raising the Top Marginal Tax Rate
(Should the Wealthy Pay More Taxes?)



This month we have really two related questions: (1) What would happen if the top marginal tax rate was raised? and (2) Should higher earners and the wealthy pay more in taxes?

(1) is a question of tax incidence and the response by high earning and wealthy taxpayers to a change in the top rate they pay. Also, how do changes in the top tax rate affect the economy at large?

(2) is not completely a question of economics. Should higher earners and the wealthy who have benefited from the advantages offered by the United States owe more than they pay now—and if so, how much more? Further, how much after tax income do people really need? Is it just a way to keep score?

With respect to (1), there is substantial evidence that changes in tax rates have little impact on the economy in general. For example, if we compare the period after the Reagan tax cuts in 1981 and the period after the Clinton tax increases in 1993, there was little difference in economic performance. In fact, the economy performed slightly better after the Clinton tax increases than it did after the Reagan tax cuts. Further evidence is the disappointing impact of the 2017 tax cuts. It has been small and is dissipating quickly. In short, most economists believe factors other than changes in the tax code are the major determinants of economic growth.

There has recently been a substantial amount of research on the "optimal" top tax rate. In one research paper two economists, Nobel laureate Peter Diamond at MIT and Emmanuel Saez at Berkeley, argue that the optimal top income tax bracket is 73%[1], higher than at any time since the 1960s.

The Diamond/Saez research lacked a detailed response until AEI released a paper by Mathur, Slavov and Strain attempting to debunk it.[2] The authors dispute Diamond and Saez, for three reasons. First, they argue that high marginal tax rates discourage people from going into higher-earning professions that may

[1] The optimal tax rate

[2] Should the optimal tax rate be 73 percent?

be socially valuable. If a bright biology major is scared away from med school by high taxes, that's bad not just for him but for all his potential patients.

Diamond and Saez argue that there's no empirical evidence for effects of this type. And indeed, it's hard to see those effects when one looks at the U.S. in the '50s, '60s and '70s, when tax rates varied from 70 to 90 percent. Second, the two sides also disagree about how people respond to taxes in the short run. Diamond and Saez argue that high earners' income varies only mildly in response to changes in taxes, whereas Mathur, Slavov and Strain think the effect is larger.

With respect to (2), in all but a very few cases, the uber-wealthy have benefited from the economic environment in which they operate. The educational, legal and technological environment in the US contributes greatly to economic success. Further, does the next dollar become less valuable as people get richer? If Bill Gates were to lose $1 million tomorrow, his life wouldn't get appreciably worse. If a poor American were to lose $10,000, that'd be a catastrophe.

This addresses a third and possibly biggest point of divergence between the two sides mentioned above. In a rarity for an economics paper, Mathur, Slavov and Strain insist that the biggest problem with Diamond and Saez is that they're wrong about political philosophy, about what we should care about when we set tax policy.

Diamond and Saez are utilitarians. Their tax policy is aimed at maximizing welfare for all Americans. That means taking money from people who don't get much welfare out of it (the rich) and giving it to those who get a lot of welfare out of it (the poor). For them, how people got that money is immaterial. Mathur, Slavov and Strain note that "social welfare in those models does not depend on how the rich got rich. Did the rich invent products that most of us can't imagine living without? Or did they get rich by lobbying for favorable regulations for their industries?" Are they rich because their parents left them enormous wealth? Some sources of income and wealth they argue, are more legitimate than others, and more deserving of protection from the government.

It's a good reminder that when you get down to basics, one can't always resolve policy arguments merely by determining what the data says or what a good model implies. There are inevitable value judgments.

Some things to ponder:

In the 1950s, a typical CEO made 20 times the salary of an average worker. Last year, average CEO pay at an S&P 500 firm was $13,940,000 a year[3]—*361 times* the pay of an average rank-and-file worker.

Research shows that there has been no correlation between the level or changes in top marginal rates and economic growth over time.

Why do we have a progressive tax system in the first place? Otherwise, we wouldn't be arguing about the proper top rate at all.

[3] CEO pay skyrockets to 361 times that of the average worker

2018 Federal Tax Brackets

Rate	Individuals	Married Filing Jointly
10%	Up to $9,525	Up to $19,050
12%	$9,526 to $38,700	$19,051 to $77,400
22%	38,701 to $82,500	$77,401 to $165,000
24%	$82,501 to $157,500	$165,001 to $315,000
32%	$157,501 to $200,000	$315,001 to $400,000
35%	$200,001 to $500,000	$400,001 to $600,000
37%	over $500,000	over $600,000