

What Would Piketty's 80 Percent Tax Rate Do to the U.S. Economy?

By Michael Schuyler, PhD

Fellow

Executive Summary

In his best seller, *Capital in the Twenty-First Century*, Thomas Piketty calls for much higher taxes on upper-income individuals. He recommends a global wealth tax and, for the United States, top income tax rates of 80 percent on income above \$5 or \$10 million to combat inequality and 50 or 60 percent on income above about \$200,000 to combat inequality and grow the government.

We used the Tax Foundation's Taxes and Growth (TAG) model to estimate the economic and revenue effects if Professor Piketty's suggested income tax rates became law.

Key Findings

- If ordinary income were taxed at the top rates of 80 and 55 percent, our model estimates that after the economy adjusts, total output (GDP) would be 3.5 percent lower, wage rates would drop 1.6 percent, the capital stock would be 7.4 percent less, and there would be 2.1 million fewer jobs.
- If capital gains and dividends were taxed at the new tax rates along with ordinary income, the economic damage would be much worse. GDP would plunge 18.1 percent (a loss of \$3 trillion dollars annually in terms of today's GDP), the capital stock would be 42.3 percent smaller than otherwise, wages would be 14.6 percent lower, 4.9 million jobs would be lost, and despite the higher tax rates, government revenue would actually fall.
- Although Piketty's proposed income tax increase may appear to target only upper-income taxpayers, all income groups would suffer from the economic fallout.
- Our model estimates that the after-tax incomes of the poor and middle class would drop about 3 percent if the higher rates do not apply to capital gains and dividends and about 17 percent if they do.

The most talked-about economics book this year is *Capital in the Twenty-First Century*.¹ This unlikely bestseller by Thomas Piketty, a professor at the Paris School of Economics, is a 685-page tome first published last year in Paris and newly translated into English. In the book, Professor Piketty declares that the essential economic problem is inequality. “It is long since past the time when we should have put the question of inequality back at the center of economic analysis and begun asking questions first raised in the nineteenth century,” he writes.²

As a solution to inequality, Piketty suggests higher taxes on the wealthiest among us. He calls for a global wealth tax, and he recommends establishing a top income tax rate of 80 percent, with a next-to-top income tax rate of 50 or 60 percent for the upper-middle class.

Piketty’s work on inequality has been lavishly praised by some economists³ but criticized by others.⁴ The aim of this paper, however, is not to comment on whether Piketty’s analysis of inequality is accurate but is instead to estimate the consequences for economic growth if the United States adopted the lofty income tax rates he recommends as part of his policy prescription.

This study begins by sketching Piketty’s views. It then provides quantitative estimates of what his proposed tax rates would mean for capital formation, jobs, the level of income, and government revenue. This study also estimates how Piketty’s proposed income tax rates would affect the distribution of income in the United States.

Piketty’s Worldview and Policy Proposals

Piketty believes income inequality is the major economic issue of our time. He places it above the level of income, poverty, and prospects for economic growth.

Piketty first presents an empirical argument. During the last fifteen years, Piketty and collaborators have assembled an enormous amount of data on income and wealth over time and across countries. His interpretation of the data is that income and wealth were very unequal in the late 19th century, became more equal by the middle of the 20th century, with much of the credit going to the wealth destruction caused by World Wars I and II and the Great Depression, but have become more unequal since the 1970s, especially in the United States.

1 THOMAS PIKETTY, *CAPITAL IN THE TWENTY-FIRST CENTURY* (Arthur Goldhammer trans., Harvard University Press 2014).

2 *Id.* at 16.

3 See, e.g., Paul Krugman, *Why We’re in a New Gilded Age*, *NEW YORK REVIEW OF BOOKS*, MAY 8, 2014, <http://www.nybooks.com/articles/archives/2014/may/08/thomas-piketty-new-gilded-age>.

4 For a small sample of the criticisms, see Alan Reynolds, *Has U.S. Income Inequality Really Increased?*, CATO INSTITUTE POLICY ANALYSIS No. 586 (JAN. 8, 2007), <http://object.cato.org/sites/cato.org/files/pubs/pdf/pa586.pdf>; Odran Bonnet, Pierre-Henri Bono, Guillaume Chapelle, & Étienne Wasmer, *Does housing capital contribute to inequality? A comment on Thomas Piketty’s Capital in the 21st Century*, Discussion paper 2014-07 (English version May 5, 2014) (Apr. 17, 2014), <http://spire.sciencespo.fr/hdl:/2441/30nstiku669glbr66l6n7mc2oq/resources/2014-07.pdf>; Abby McCloskey, *No, it’s not the end of capitalism. An alternative to Thomas Piketty’s ‘terrifying’ future*, AMERICAN ENTERPRISE INSTITUTE AEI IDEAS BLOG, Apr. 15, 2014, <http://www.aei-ideas.org/2014/04/no-its-not-the-end-of-capitalism-a-conservative-response-to-piketty>; Laurence Kotlikoff, *Will The Rich Always Get Richer?*, *FORBES*, May 15, 2014, <http://www.forbes.com/sites/kotlikoff/2014/05/15/will-the-rich-always-get-richer>.

In addition, Piketty claims to have discovered a basic economic law, which he calls the “fundamental force for divergence,”⁵ that supposedly pushes market economies toward extreme wealth and income inequality. If the rate of return on capital exceeds the rate of economic growth (expressed symbolically as $r > g$), Piketty thinks capital owners will accumulate wealth and income over generations, becoming ever richer compared to the rest of the population.

The rate of return on capital does often exceed the rate of growth, but Piketty is mistaken in thinking it implies an ever-increasing concentration of wealth. In reality, and for many reasons, wealth is often fleeting. Consider the following example. A person who works and saves successfully in his or her prime years may spend much of that wealth in retirement and bequeath little. If the person does leave a large fortune, it will be dispersed across a growing population of heirs. Moreover, heirs often deplete inheritances by the second or third generation through poor business decisions, lack of interest in making money, or lavish spending.

Piketty’s policy recommendations are striking. He advocates a global wealth tax of 1 or 2 percent annually on the net worth of millionaires or semi-millionaires (perhaps rising to 5 or 10 percent annually on the wealthiest).⁶ Piketty says that full realization of his global wealth tax may be “unrealistic” and “utopian,” but he continues that “it is perfectly possible to move toward this ideal solution step by step.”⁷

Further, Piketty recommends that the top income tax rate be raised to 80 percent or so. He also suggests that a 50 to 60 percent rate be imposed on upper-middle incomes below the top bracket (a less-publicized element of his tax proposal). Noting that income tax rates in the United States and Britain were once even higher, he views an 80 percent income tax as feasible and achievable. But he warns that getting there may have to await “a radical shock” because “[t]he experience of France in the Belle Époque proves, if proof were needed, that no hypocrisy is too great when economic and financial elites are obliged to defend their interests.”⁸

Professor Piketty is clearly more interested in the redistribution of income than the production of income. He expresses little concern about the effect of extremely high tax rates on growth and employment. Far from acknowledging a tension between redistribution and growth, Piketty portrays redistributive tax policies as a free lunch, either causing little harm to growth or actually contributing to growth. He writes that increasing the top income tax rate to 80 percent “would not reduce the growth of the US economy but would in fact distribute the fruits of growth more widely”⁹

5 PIKETTY, *SUPRA* NOTE 1, AT 25.

6 *Id.* at 517.

7 *Id.* at 515-516.

8 *Id.* at 514.

9 *Id.* at 513.

What about Economic Growth?

To supply a different perspective, this paper uses the Tax Foundation's Taxes and Growth model¹⁰ to estimate the long-run growth implications if Professor Piketty's income tax recommendations were adopted in the United States. In contrast to his rosy scenario, the model estimates that an 80 percent top income tax rate and a 50 to 60 percent next-to-top rate would drastically reduce investment, wages, jobs, production, and incomes. The model further predicts that the pain would be felt by people at all income levels, not just the top earners.

We do not model Piketty's wealth tax in this paper. Although our Taxes and Growth model is capable of doing so, the results would be more speculative than for an income tax because of data limitations. In addition, a broad-based federal wealth tax might face a constitutional barrier¹¹ and would certainly encounter enormous administrative and enforcement problems. An earlier version of our model did examine the effects of the U.S. estate and gift tax regime, which can be thought of as a wealth tax assessed at death. The model estimated that although only a small fraction of estates have death tax liabilities, almost everyone ultimately pays the tax, because it leads to significant reductions in capital formation, jobs, and incomes.¹²

Piketty's Income Tax Proposal

Piketty would begin with an income tax "rate on the order of 80 percent on incomes over \$500,000 or \$1 million a year" to combat inequality and greed.¹³ As mentioned earlier, the professor scoffs at the notion that this almost confiscatory tax rate would slow production. "The idea that all US executives would immediately flee to Canada and Mexico and no one with the competence or motivation to run the economy would remain is not only contradicted by historical experience and by all the firm-level data at our disposal; it is also devoid of common sense."¹⁴

The only significant change in behavior Piketty envisions is that his "dissuasive taxation"¹⁵ would reduce how hard executives bargain for compensation, with the result, supposedly, that they would work the same as before but for less money. The bright side of this, according to Piketty, is that more of the economic pie would be left for the 99 percent; the dark side, in his eyes, is that the government would not raise additional revenue. He explains, "A rate of 80 percent applied to incomes above \$500,000 or \$1 million a year would not bring the government much in the way of revenue, because it would quickly fulfill its objective: to

10 See the appendix for a description of our model.

11 Congress and the states overrode the restriction in the case of the individual income tax with the Sixteenth Amendment, but the Sixteenth Amendment says nothing about allowing a federal wealth tax.

12 See Stephen J. Entin, *Not Ideologically Neutral or Revenue Neutral: Joint Tax Committee Revenue Estimates Omit Economic Impact of Estate Tax Changes on Economic Growth, Jobs, and Incomes for All Americans* (Jan. 20, 2011), http://nodeathtax.org/uploads/view/2328/jct_study_final.pdf.

13 PIKETTY, *supra* note 1, at 513.

14 *Id.*

15 *Id.* at 512.

drastically reduce remuneration at this level but without reducing the productivity of the US economy, so that pay would rise at lower levels.”¹⁶

Like many people in France, including the leaders of the current French government, Piketty generally supports the platform of the French Socialist Party and believes in big government. Looking to the United States, he thinks the U.S. government should collect more tax dollars in order to spend more. As such, his guess that the 80 percent tax rate would not raise much revenue distresses Piketty. That concern leads to the second part of his income tax proposal: a 50-60 percent rate bracket starting at a much lower income. “In order for the [U.S.] government to obtain the revenues it sorely needs to develop the meager US social state and invest more in health and education (while reducing the federal deficit), taxes would also have to be raised on incomes lower in the distribution (for example, by imposing rates of 50 or 60 percent on incomes above \$200,000).”¹⁷

How Piketty Claims People React to Taxes

According to Piketty, people do not like paying taxes and will try hard to escape them. That is why he believes tax enforcement needs to be enhanced, and why he recommends that his proposed wealth tax be global.

When it comes to deciding how much to work and invest, however, Piketty claims people (or at least the upper-income people he would tax so heavily) are totally insensitive to marginal tax rates. In his world view, upper-income taxpayers will work and invest just as much as before even if dramatically higher taxes reduce their after-tax rewards to a fraction of what they were previously. He further thinks that heavily taxed executives, while working as hard as before, will accept lower pre-tax compensation because they would gain so little on an after-tax basis from being paid more. In this vision, extremely high tax rates do not hurt economic growth; they merely persuade upper-income taxpayers to accept lower pre-tax returns (and much lower after-tax returns), which leaves more of the economic pie for the poor and middle class.

Piketty’s vision of the world strains credulity. Given people’s vigorous efforts to escape taxes, which suggests a good bit of tax sensitivity, it is implausible they would refuse to adjust how much they work and invest in response to changes in their marginal tax rates. Piketty’s scenario is also at odds with basic human nature and many empirical studies. While there are some people who derive so much pleasure from working and investing that they would do as much almost regardless of compensation, they are a small minority.

How the Proposal Was Modeled

To model Piketty’s top individual income tax rate, we added a new tax bracket of 80 percent, starting at \$750,000 (splitting the difference between \$500,000 and \$1 million). Piketty does not specify whether his proposed 80 percent bracket

¹⁶ *Id.* at 513.

¹⁷ *Id.*

would begin at the same income for singles and heads of households as for joint filers. Tax brackets usually have lower income thresholds for singles and heads of households than for joint filers, but, on the other hand, the starting point for the top rate bracket did not depend on filing status from 1993 through 2012. With that in mind, we assume Piketty's 80 percent bracket would begin at \$750,000 for all these filers.¹⁸ (If the income threshold were lower for singles and heads of households, the effects would be similar, but even larger, than those described below. If the threshold were \$500,000 for single filers and \$1 million for couples, the effects would be about the same as at \$750,000 for both.)

For the new next-to-top bracket, we assumed its rate would be 55 percent (splitting the difference between 50 and 60 percent). We assumed it would begin where the current 33 percent bracket starts. In 2013, that threshold was \$223,051 for joint filers, \$183,251 for singles, and \$203,051 for heads of households.

Piketty does not specifically discuss how he would tax capital gains and dividends. Accordingly, we modeled two scenarios. In the first scenario, the maximum tax rate on long-term capital gains and qualified dividends is assumed to remain capped as under current law. In the second scenario, the rate cap is assumed to be abolished and the same tax rate schedule applied to long-term capital gains and qualified dividends as to other income. Given Piketty's warnings about capital accumulation, he would probably favor the second scenario.

The Economic Results of the Piketty Proposal

Scenario 1. The Economic and Revenue Effects of Professor Piketty's 55 and 80 Percent Tax Rates, with No Change in the Tax Treatment of Capital Gains and Dividends

Under Piketty's 55 and 80 percent tax brackets, people in the new, ultra-high tax brackets will work and invest less because they will be able to keep so little of the reward from the last hour of work and the last dollar of investment. The assumed continuation of the tax-rate caps on long-term capital gains and qualified dividends will shield much, but by no means all, investment income from Piketty-level tax rates.

As the supplies of labor and capital in the production process decline, the economy's output will also contract. Although it is only people with upper incomes who will directly pay the 55 and 80 percent tax rates, people throughout the economy will indirectly bear some of the tax burden. For example, the average person's wages will be lower than otherwise because middle-income workers will have less equipment and software to enhance their productivity, and wages

¹⁸ Two technicalities should be noted. First, the \$750,000 is deflated into 2008 dollars for consistency because our Taxes and Growth model uses tax data from the IRS's 2008 Public Use File. Second, the threshold for married couples filing separately is assumed to be half of that for joint filers.

depend on productivity. Similarly, people throughout the economy will have fewer employment opportunities and will lose desirable goods and services, because businesses will grow more slowly and be less innovative.

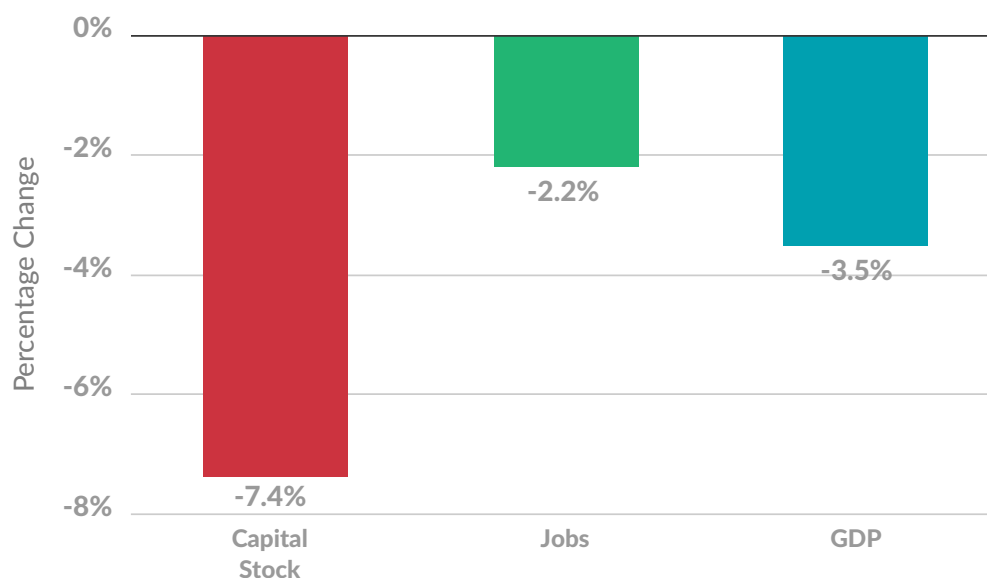
Table 1 and Chart 1 present the results. The model estimates that after the economy has adjusted to the 55 and 80 percent tax rates, the stock of private business capital will be down 7.4 percent, the wage rate will drop 1.6 percent, there will be 2.1 million fewer jobs, and the economy's total output of goods and services (GDP) will be 3.5 percent lower. A static revenue estimate would show

Table 1. Top Individual Income Tax Brackets of 55% and 80%;
No Change in Tax Treatment of Capital Gains and Dividends

"Economic and Budget Changes Compared to Current Tax System (Billions of 2013 dollars except as noted)"	
GDP	-3.50%
GDP (\$ billions)	-\$571.4
Private business GDP	-3.79%
Private business stocks	-7.36%
Wage rate	-1.63%
Private business hours of work	-2.20%
Full-time equivalent jobs (in thousands)	-2,120
Static federal revenue estimate, GDP assumed constant (\$ billions)	\$292.9
Dynamic federal revenue estimate after GDP gain or loss (\$ billions)	\$141.8
Weighted Average service price	% Change
Corporate	-0.37%
Noncorporate	13.84%
All business	3.86%

Source: Tax Foundation calculations

Chart 1. Top Individual Income Tax Brackets of 55% and 80%
No Change in Tax Treatment of Capital Gains and Dividends



Source: Tax Foundation calculations

the government gaining nearly \$300 billion from the higher taxes. However, because of the negative feedback from the smaller and weaker economy, the federal government's actual dynamic revenue gain will be less than half of that.

Scenario 2. The Economic and Revenue Effects of 55 and 80 Percent Tax Rates, with Capital Gains and Dividends Taxed as Ordinary Income

Although Piketty does not specifically say how he would treat long-term capital gains and qualified dividends, his criticism that the returns on saving and investing lead to excessive inequality unless the government intervenes suggests he would want to abolish the rate cap and tax capital gains and dividends as ordinary income. That would increase the top rate on capital gains and dividends fourfold, from 20 percent to 80 percent. Many savers and investors now paying at a 15 percent tax rate would see an almost-fourfold jump to 55 percent. (The rates are actually higher because the federal tax system phases out various deductions, exemptions, and credits with rising income, because it imposes a 3.8 percent surtax on the investment returns of upper-income taxpayers, and because most states also tax income. The Taxes and Growth model takes account of these rate bumps and state-level taxes.) When these drastic marginal tax increases are combined with the extreme sensitivity of saving and investing to expected after-tax returns, the outcome would be a plunge in investment, leading to a dramatically smaller capital stock.

The results can be seen in Table 2 and Chart 2 on the following page. Let's first look at the service price of capital, also known as the hurdle rate. This is the before-tax return demanded on potential investments in order to cover taxes, depreciation, inflation, and risk and still earn a satisfactory real, after-tax return. Piketty's tax rates would raise the hurdle rate on investment by slightly over 40 percent on average. Far fewer investment projects would be able to jump that hurdle. The model predicts that, after all adjustments, the capital stock would be 42.3 percent smaller than otherwise, wages would be 14.6 percent lower, 4.9 million jobs would be lost, and the overall economy would be 18.1 percent smaller than otherwise. In terms of the current GDP of about \$17 trillion, that is a GDP loss of over \$3 trillion annually.

In trying to envision the adjustment path, the Japanese experience may be relevant.

From the early 1960s to the mid-1980s, the Japan economy was often described as an economic miracle, rising from wartime ruin to become the second-largest economy in the world. Throughout that period, the Japanese tax system was friendly to saving and investment. It did not favor those activities over immediate consumption, but it also did not seriously disadvantage them. In the late 1980s, however, Japan sharply increased taxes on the returns from saving and investing. Soon thereafter, most of the growth vanished and was replaced, for a generation, by slow growth or stagnation.

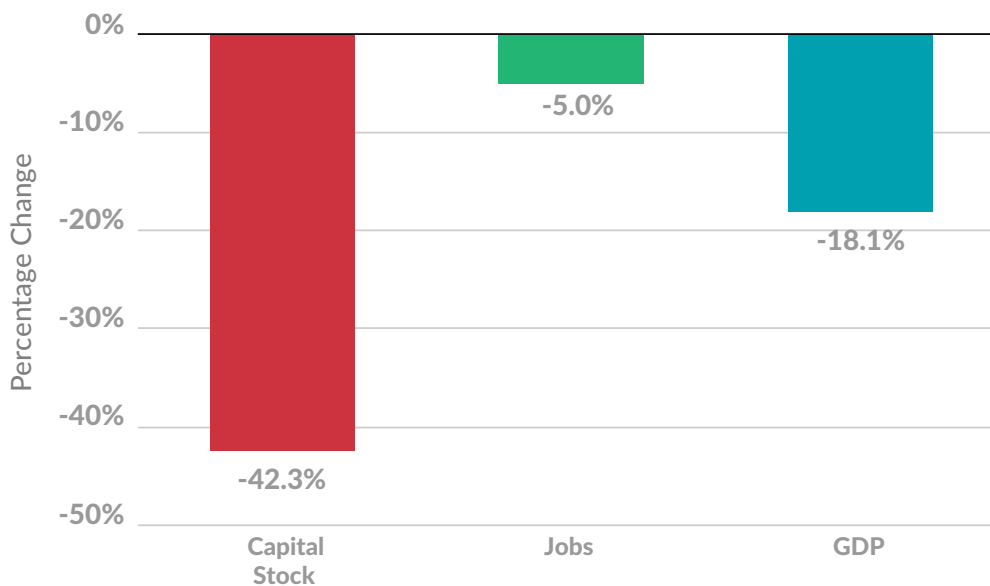
Table 2. Top Individual Income Tax Brackets of 55% and 80%;
Capital Gains and Dividends Taxed as Ordinary Income

"Economic and Budget Changes Compared to Current Tax System (Billions of 2013 dollars except as noted)"	
GDP	-18.11%
GDP (\$ billions)	-\$2,952.6
Private business GDP	-18.88%
Private business stocks	-42.34%
Wage rate	-14.58%
Private business hours of work	-5.04%
Full-time equivalent jobs (in thousands)	-4,851
Static federal revenue estimate, GDP assumed constant (\$ billions)	\$578.3
Dynamic federal revenue estimate after GDP gain or loss (\$ billions)	-\$243.8
Weighted Average service price	% Change
Corporate	53.05%
Noncorporate	11.46%
All business	40.68%

Source: Tax Foundation calculations

Chart 2. Top Individual Income Tax Brackets of 55% and 80%

Capital Gains and Dividends Taxed as Ordinary Income



Source: Tax Foundation calculations

Judging by that experience, the United States might adjust to Piketty-style income tax rates not through a sudden violent downturn but through ten or twenty years of slow growth. At the end of the period, the capital stock would be about 40 percent smaller, there would be approximately 5 million fewer jobs, and output would be nearly 20 percent lower than if we had enjoyed normal growth. (For example, let's assume the economy would normally grow 2.5 percent annually over the next decade but that Piketty's tax increases would flatten the growth rate to half a percent yearly. That would make the level of GDP 18 percent lower than otherwise by the end of the tenth year.)

If this tax increase did not shrink the economy, it would be an immense revenue raiser, bringing in almost \$600 billion. However, because of the massive negative revenue feedback due to the smaller economy, the dynamic estimate predicts a huge federal revenue loss of almost \$250 billion.

The Distributional Effect of Piketty's Tax Increase: Lower Wages for Everyone

Table 3 examines the distributional effects of the proposed 55 and 80 percent tax brackets. If the higher rates had no growth effects, they would leave the bottom 90 percent of tax filers either entirely untouched or almost untouched, depending on whether capital gains and dividends keep their own rate schedule or are taxed as ordinary income. Meanwhile, the 55 and 80 percent tax brackets would lower the after-tax incomes of the top 1 percent of income tax filers by either 18.8 percent or 36.2 percent, depending on whether capital gains and dividends retain their current rate schedule or share in the tax rate increase.

Table 3
Distributional Analysis

	Scenario 1		Scenario 2	
	Top Tax Brackets of 55% and 80%; No Change in Taxation of Capital Gains and Dividends"		Top Tax Brackets of 55% and 80%; Capital Gains and Dividends Taxed as Ordinary Income"	
All Returns with Positive AGI	Static	Dynamic	Static	Dynamic
Decile Class	Aftertax AGI	Aftertax AGI	Aftertax AGI	Aftertax AGI
0% to 10%	0.0%	-3.1%	0.0%	-16.4%
10% to 20%	0.0%	-3.1%	0.0%	-16.2%
20% to 30%	0.0%	-3.1%	0.0%	-16.6%
30% to 40%	0.0%	-3.1%	-0.1%	-16.6%
40% to 50%	0.0%	-3.1%	-0.1%	-16.7%
50% to 60%	0.0%	-3.2%	-0.1%	-16.8%
60% to 70%	0.0%	-3.2%	-0.2%	-16.9%
70% to 80%	0.0%	-3.1%	-0.2%	-16.9%
80% to 90%	0.0%	-3.0%	-0.3%	-16.4%
90% to 100%	-8.2%	-10.7%	-15.8%	-27.6%
95% to 100%	-11.0%	-13.4%	-21.2%	-31.6%
99% to 100%	-18.8%	-21.0%	-36.2%	-43.3%
99.5% to 100%	-21.6%	-23.7%	-42.2%	-48.5%
99.9% to 100%	-25.4%	-27.6%	-53.4%	-58.4%
TOTAL FOR ALL	-3.31%	-6.20%	-6.53%	-21.13%

Source: Tax Foundation calculations

The picture changes when growth effects are considered. Now the poor and middle class would also lose. They would suffer a large, but indirect, tax burden as a result of the smaller economy. Their after-tax incomes would fall over 3 percent if capital gains and dividends retain their current-law tax treatment and almost 17 percent if capital gains and dividends are taxed like ordinary income. Everyone, including the wealthy, would suffer from the slower growth. The top 1 percent of tax filers would see their after-tax incomes fall by either 21.0 percent or 43.3 percent, depending on whether or not capital gains and dividends retain their current rate schedule.

The 55 and 80 percent tax brackets would lessen after-tax income inequality. However, the narrowing of income differences would not be accomplished by increasing the pre-tax incomes of the poor and middle class as Piketty seems to think but by reducing the after-tax incomes of everyone.

In evaluating this method of equalizing income, a reasonable question to ask is whether a middle-income family is made better off if their income drops 3.2 percent while the income of a family in the top 1 percent drops 21.0 percent, or their income plummets 16.8 percent while the income of a family in the top 1 percent plummets 43.3 percent.

Piketty believes a benefit of higher taxes is that the government will have more money to redistribute to the poor and middle class. If the revenues materialized and the higher government spending helped the poor and middle class, Table 3 might be painting too bleak a picture for those groups. In the scenario where the top tax rates jump to 55 and 80 percent but the rate cap on capital gains and dividends remains in place, some amelioration would be possible. However, even if every cent of added government revenue were spent on the poor and middle class, that would fall short of the income lost by those groups due to the tax-induced economic slowdown. In the scenario where the top tax rates climb to 55 and 80 percent and the rate cap on capital gains and dividends is abolished, Table 3 is actually too optimistic. Because of the dramatic economic decline caused by the higher taxes, government revenue would be lower than otherwise. To avoid going farther into debt, the government would have to cut its spending. Many of the cuts would unavoidably fall on transfer programs for the poor and middle class because those programs are such a large share of the budget.

Additional Implications of Piketty's Tax Increases

If tax brackets of 55 and 80 percent became law, taxpayers potentially subject to those rates would become acutely interested in finding ways around them. Avoidance refers to legal workarounds, such as shifting more compensation into tax-favored fringe benefits, while evasion refers to illegal ones. The Taxes and Growth model does not include avoidance and evasion in its estimates.

Two imprecise but plausible guesses are that avoidance and evasion would soften the adverse economic effects of the extremely high rates but cause problems of their own. For example, people in many countries, and at all income levels, have responded to high tax rates by turning tax evasion into an art form. That makes it easier to live with heavy taxes but undermines the government's ability to collect revenue and has a corrosive effect on the rule of law.

It should be noted that because the 55 and 80 percent tax rates would strongly encourage avoidance and evasion, the reported incomes of upper-income taxpayers would drop by more than their actual incomes. That effect, which the model does not estimate, would look like a narrowing of income inequality but the reduction would be illusory.

Conclusion

The top individual income tax brackets that Piketty recommends—50 to 60 percent and 80 percent—would have the direct effect of reducing after-tax income inequality in the United States but the indirect effect of making people at all income levels significantly poorer.

If Congress enacted Piketty's tax rate increases while retaining the current rate cap for long-term capital gains and qualified dividends, the Tax Foundation's Taxes and Growth model estimates that, after the economy had adjusted, the stock of equipment, structures and other capital used in production would be 7.4 percent lower than otherwise, 2.1 million jobs would be lost, and GDP would be 3.5 percent lower than otherwise (a loss of about \$575 billion annually in terms of today's GDP). The rate cap for long-term capital gains and qualified dividends moderates the damage by shielding much saving and investment from the higher rates. If Congress also abolished the rate cap, the model estimates that the long-run harm would be many times worse: something close to the deindustrialization of the U.S. economy with the capital stock down 42.3 percent, 4.9 million fewer jobs, and 18.1 percent less GDP than otherwise (a loss of about \$3 trillion annually in terms of today's GDP).

Although Piketty is entertaining and dramatic, he is swimming against the tide with his tax proposals. Governments that experimented in the past with stratospheric income tax rates eventually concluded the sky-high rates were bad for economic growth, ineffective as revenue raisers, and politically divisive. They lowered the rates.

It briefly appeared that Piketty's home country of France would give extreme tax rates a new real-world test. The French recently imposed a 75 percent top income tax rate. However, its reach is much narrower than Piketty has proposed. Moreover, in response to a poor economy and collapsing polling numbers, President Francois Hollande's government has reversed course and announced that France's corporate income tax rate will be cut to 28 percent over the next several years.¹⁹

Piketty fears that capital accumulation will lead to undesirable inequality, and he seeks to cure that. It is not at all clear his diagnosis is correct, but even if it were, his proposed cure would be much worse than the disease.

The Tax Foundation is a 501(c)(3) non-partisan, non-profit research institution founded in 1937 to educate the public on tax policy. Based in Washington, D.C., our economic and policy analysis is guided by the principles of sound tax policy: simplicity, neutrality, transparency, and stability.

©2014 Tax Foundation

Editor, Donnie Johnson
Designer, Dan Carvajal

Tax Foundation
National Press Building
529 14th Street, NW,
Suite 420
Washington, DC
20045-1000

202.464.6200

taxfoundation.org

¹⁹ Gregory Viscusi, Helene Fouquet, & Mark Deen, *Valls Pledges Tax, Spending Cuts to Boost French Economy*, BLOOMBERG, Apr. 8, 2014, <http://www.bloomberg.com/news/2014-04-08/valls-pledges-tax-spending-cuts-to-boost-french-economy.html>.

Appendix

After-Tax Incentives Drive the Taxes and Growth Model

The Tax Foundation's website describes our Taxes and Growth model in detail,²⁰ but it may be useful to provide a short summary here. The model begins with a tax calculator that estimates how a tax change would alter federal revenue under the assumption that the tax modification does not affect the overall size of the economy. The Joint Committee on Taxation (JCT), which provides Congress with revenue scores for proposed tax legislation, normally makes this static assumption, although it does allow for tax-related shifts and some degree of tax avoidance within the economy while holding total economic activity fixed.²¹

The Taxes and Growth model's tax calculator also estimates how the proposed tax change would affect marginal tax rates and, from that, the after-tax rewards for working and investing. Because people respond to incentives, including those of the tax system, a tax change that makes work and investment less (more) rewarding will induce people to work and invest less (more). Because investment is extremely sensitive to expected after-tax returns, capital formation will respond very strongly to changes in the marginal tax rates on equipment, structures, and other capital goods. The model then estimates how the tax-induced changes in work effort and the capital stock will affect the economy's production of goods and services. Further, because tax collections depend on economic activity (think of how tax collections swell during booms and plunge during recessions), the Taxes and Growth model generates a dynamic revenue estimate that takes account of the economic feedback from the initial tax change.

The model is long run, and it estimates the ultimate changes in government revenue and economic activity after the economy has adjusted to the new tax rules. The model does not show the year-by-year adjustment path for government revenue and economic activity. The adjustment process is obviously not instantaneous, but it is not very long. Based on past history, it is likely that most of the adjustments in the stocks of equipment and structures will be completed within five and ten years, respectively.

With tax changes that do not have much effect on marginal tax rates (a higher or lower standard deduction is an example), the quantities of labor and capital supplied to the production process also do not change by much, and the dynamic economic and revenue estimates are close to the static ones. If the marginal tax changes are large, however, the static and dynamic estimates can differ greatly.

²⁰ See Tax Foundation, *Taxes and Growth*, <http://taxfoundation.org/taxes-and-growth>. See also Michael Schuyler, *The Taxes and Growth Model—A Brief Overview*, TAX FOUNDATION FISCAL FACT No.429 (May 6, 2014), <http://taxfoundation.org/article/taxes-and-growth-model-brief-overview>.

²¹ Earlier in 2014, in estimating the effects of the tax plan proposed by Rep. Dave Camp (R-IL), Chairman of the Ways and Means Committee, the JCT did prepare dynamic estimates to supplement the conventional estimates, but that is unusual and required a direct request from Chairman Camp.