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Hillary & Bernie, Tax Fantasists

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Here is a question to ask Hillary Clinton and Bernie Sanders: What is the best tax rate to impose on high-income earners to ensure there is enough government revenue to pay for your trillion-dollar promises to voters?

Perhaps they think it is 83%, a rate that economists Thomas Piketty and Emmanuel Saez hypothesized in 2014 in a widely circulated paper. Or maybe it is 90%, which Sen. Sanders told CNBC last May was not out of the question. “Our job is not to think small,” Mr. Sanders elaborated in the Huffington Post a month later. “It is to think big.”

Progressives have often reminded us that the U.S. had such rates in the past. From 1936 to 1980, the highest federal income-tax rate was never below 70%, and the top rate exceeded 90% from 1951 to 1963. Under Ronald Reagan, the top federal rate declined to 28% by 1988 and has never reached 40% since.

The discussion of these rates can easily create the impression that the federal government collected far more money from “the rich” before the Reagan administration. And it can also leave another impression: There would be no downside to raising rates to 1950s levels, given that decade’s prosperity.

Neither impression would be correct. The effective tax rates actually paid by the highest income earners during the 1950s and early ’60s were far lower than the highest marginal rates. Few taxpayers reached the top brackets, the code was rife with loopholes, and capital gains were taxed at much lower rates.

In the 1960s, for example, the average rate paid by the top 0.1% of tax filers—the top 10th of the top 1%—ranged from 26.5% to 29.5%, according to a 2007 study by Messrs. Piketty and Saez. Even during the 20 years after the Reagan tax cuts, the top 10th of the top 1% paid an average rate of 23.7% to 33%—essentially the same as in the 1960s. In the decade following 2001, the Congressional Budget Office estimates that the average rate for this elite group never exceeded 32%.

Nostalgia aside for a world that never existed, few people paid the top tax rates of the 1950s and early 1960s. Of course, when they did, the top marginal rates applied only to income above a very high threshold. The top ordinary income rate married couples faced in 1960, 91%, applied only to income above $2.5 million in today's dollars.

Suppose a President Clinton or Sanders tried to raise effective tax rates paid by a significant number of upper-income earners through very high top rates. What then? Real damage, according to Mr. Piketty. In a 2009 debate with the Cato Institute's Chris Edwards in the Economist, Mr. Piketty said, "I firmly believe, that imposing a 70% or 80% marginal rate on large segments of the population (say, 25% of the population, or even 10%, or even a few percentage points) would lead to an economic disaster." In other words, sayonara increased tax revenue.

Even without disaster, however, it is unclear whether higher rates on the upper echelons of the top 1% would bring in more revenue. I've compared the Piketty-Saez estimates of average federal income-tax rates paid by the top 10th of the top 1% with the revenue collected at the federal level from the same group. The result? From the mid-1960s through the '80s, trends in the average tax rates paid at the top compared with their tax revenues are mirror images. When average tax rates went up from 27.6% in 1965 to 34% in 1975, revenues went down, from 0.6% to 0.5% of the sum of GDP plus capital gains. When average tax rates declined to 23.7% over the second half of the 1970s and the '80s, tax revenues from the top went up, reaching 0.8% of GDP plus capital gains in 1990.

This makes intuitive sense. Of all Americans, it is the wealthy who are more likely to take advantage of legal ways to reduce their payments when rates rise. Plus, their work and investment decisions are more sensitive to the after-tax payoff.

Admittedly, in the early 1990s, Presidents George H.W. Bush and Bill Clinton raised average tax rates at the top, and revenue from the top 0.1% eventually skyrocketed. But the flood of revenue overwhelmingly reflected not the increase in rates but the stock market's takeoff beginning in late 1994, which resulted in a corresponding rise in income from capital gains and stock options.

Consider: If the higher top tax rates had caused the growth in revenue, then revenues should have fallen when Mr. Clinton cut the top tax rate on capital gains to 20% from 28% in 1997. But revenues from the top 0.1% kept pouring in.

Proposals to soak the rich by raising their tax rates are unlikely to yield the revenue windfall that Mr. Sanders or Mrs. Clinton are dangling before voters. Leveling with the American people means either scaling back their agendas or admitting that they will have to raise the money from tax hikes on middle-class voters.