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Atlas Doesn't Shrug on Tax Rise as Saez-Piketty Refutes Rand

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May 1 (Bloomberg) -- Atlas won't shrug.

That's the view of economists Emmanuel Saez and Thomas Piketty: They argue higher taxes will not discourage the wealthy from working harder or slow the economy, unlike in Ayn Rand's 1957 novel, "Atlas Shrugged." Its hero, John Galt, led a strike by industrialists and others against the government, partly because they thought they were too highly taxed.

"Top 1 percent earners now make 20 times the average, while they made only 10 times the average in the 1970s," Saez, winner of the John Bates Clark young economist award in 2009, said in an e-mail. "If they worked hard then, they should continue working hard today, even if they are taxed at 50 percent." The top federal tax rate is now 35 percent.

The two economists' work is of more than just academic interest. President Barack Obama's former budget director, Peter Orszag, has said their research on income inequality "helped to point the way for the administration in its pledge to rebalance the tax code." Senate Republicans last month blocked Obama's plan to raise taxes on the rich via the so-called Buffett rule, arguing it would hurt the economy.

"High marginal tax rates distort decisions to work, save, invest and start a business," Glenn Hubbard, an economic adviser to Republican presidential candidate Mitt Romney, said in an e-mail.

In France, Socialist presidential candidate Francois Hollande has called for a 75 percent tax on annual incomes of more than 1 million euros ($1.3 million), a proposal championed by Piketty, a professor at the Paris School of Economics. Polls show Hollande leading over incumbent President Nicolas Sarkozy in advance of May 6 elections.

'Just Crazy'

"The idea that we need to pay people many millions of euros per year to get them to work harder is just crazy," Piketty said in a telephone interview.

He and Saez, a professor of economics at the University of California-Berkeley, agreed in a November 2011 paper that the rich do behave differently when their taxes are raised. They pursue financial strategies to reduce their taxable incomes and bargain for higher

compensation, instead of cutting back on how much they work and save or becoming less entrepreneurial.

Peter Diamond, who won the 2010 Nobel Prize in economics, also sees little evidence that raising rates on the top 1 percent of income earners -- households making about $350,000 or more a year in 2010 -- would restrict growth.

'Overwhelming Likelihood'

"The overwhelming likelihood is that the revenue- maximizing federal tax rate is somewhere in the 50 to 70 percent range," said Diamond, a professor at the Massachusetts Institute of Technology in Cambridge. "If you are reluctant to overshoot, well okay, you can only go up to 50 percent, which I like to refer to as the Reagan tax rate."

Lionized by Republicans, the late Ronald Reagan championed an across-the-board tax cut soon after he became president in 1981 that lowered the top rate to 50 percent from 70 percent. He subsequently pushed it to 28 percent as part of an overhaul of the tax code in 1986.

The economy actually grew faster in the 30 years before that tax cut than it did during the following three decades, according to Diamond and Saez. Gross domestic product per capita advanced at an average annual 2.2 percent rate between 1950 and 1980, compared with 1.7 percent between 1980 and 2010, their calculations show.

Internationally, advanced economies that have reduced top tax rates the most since 1975 haven't shown a tendency to grow faster than those that cut less, Piketty, Saez and Stefanie Stantcheva, an economist and Ph.D. student at MIT, found in the November 2011 paper.

Faster Growth

Their data ignore such emerging-market economies as Brazil and India, which have lowered top tax rates and enjoyed faster growth than developed nations, said Alan Reynolds, a senior fellow at the Cato Institute in Washington.

Brazil's economy has expanded at an average annual pace of 3.6 percent since 2000, more than double the 17-nation euro area's 1.4 percent.

The British government is worried enough about the economic impact of high taxes on the wealthy that it has said it will reduce its top rate to 45 percent next year from 50 percent now.

No government "can justify a tax rate that damages our economy and raises next to nothing; it's as simple as that," Chancellor of the Exchequer George Osborne told Parliament in London on March 21.

Tax Avoidance

It's not only through "reduced work effort" by the rich that higher tax rates can hurt the economy, Martin Feldstein, a professor at Harvard University in Cambridge, Massachusetts, said in an e-mail. Stepped-up tax avoidance also can impede economic efficiency by diverting money and attention away from more productive purposes, said Feldstein, president emeritus of the National Bureau of Economic Research, which determines when U.S. recessions begin and end.

Such efforts -- which include taking more compensation in the form of tax-advantaged health-care benefits -- reduce revenue for the government and "increase deadweight losses" for the economy, he added.

Very high top tax rates also may have long-run effects on growth that aren't immediately discernible, said Joel Slemrod, chair of the economics department at the University of Michigan in Ann Arbor.

"New people coming into the labor force might decide it's not worth it" to try so hard to get ahead, he said.

Depressed Labor Supply

High taxes have depressed the labor supply in European economies, according to economist Edward C. Prescott, a Nobel laureate, who argues that Americans generally work more hours because U.S. tax rates are lower. The result: U.S. inflation- adjusted GDP per capita in 2010 was about 40 percent higher than the average for the euro area, according to data from the Organization for Economic Cooperation and Development in Paris.

"This is nonsense," said the Piketty, 40, a visiting professor at MIT in 2000-2001. "When people in Europe have five weeks of vacation, this is not in response to high tax rates."

Saez, 39, said increases in top rates should be coupled with steps to close loopholes and broaden the tax base to limit the avoidance efforts Feldstein worries about.

Capital-gains taxes should be raised as well, said Saez, a French and U.S. citizen. That would discourage business leaders from trying to take more of their compensation in shares, rather than salary, to avoid paying higher income-tax rates. The top U.S. rate on long-term gains is 15 percent.

Move Together

Taxes on capital and labor income earned by the wealthy "don't have to match, but they should move together and shouldn't be too far apart," Diamond said.

An increase would hurt the stock market and the economy, argued Romney adviser Hubbard, who is also dean of the graduate business school at Columbia University in New York.

"Because evidence suggests that higher dividend- and capital-gains taxes are capitalized in equity values, increasing those tax rates will reduce stock prices and the wealth of

millions of Americans," he said. A rise would discourage investment, "leading to lower productivity, wages and output."

Saez and Piketty also have faced criticism for their research on income inequality. Using tax returns, the two academic economists concluded that the top 1 percent of U.S. earners have more than doubled their share of income during the last half century, to about 20 percent in 2010 from less than 10 percent in the 1970s.

Fluctuations in Earnings

The research says more about fluctuations in earnings reported for tax purposes in response to changes in the tax code than it does about inequality, Cato's Reynolds said.

Another critic, Scott Winship, said he has become less skeptical of Saez and Piketty's work as other studies show income differences widening -- albeit perhaps not to the extent the academics do.

"The general trend is still toward increasing inequality," said Winship, a fellow at the Brookings Institution in Washington.

The Congressional Budget Office said in an October report that the share of income received by the top 1 percent grew from about 8 percent in 1979 to over 17 percent in 2007.

In its calculations, the Washington-based CBO takes account of government transfer payments, primarily from Social Security, and company-paid health-insurance benefits, neither of which Saez and Piketty consider.

Growing Inequality

Even after those adjustments, the rapid growth of income for the top 1 percent remains "a major factor" contributing to growing inequality, the CBO report said.

That's reflected in the Occupy Wall Street movement's motto, "We are the 99 percent," and its calls for a more even distribution of wealth. Demonstrators took to the streets in May Day protests today across the U.S., sending a singing "Guitarmy" to Manhattan's Union Square and smashing windows in Seattle.

Diamond and Saez contributed an essay about higher taxes on the rich to the "Occupy Handbook," a compendium published last month as a guide to the movement.

"I have no problem with the rich per se," Piketty said. "But what we're talking about is completely insane income in my view that people are just extracting from the economy which has nothing to do with their performance."

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