US INEQUALITY: New evidence of the impact of taxes, transfers and technology

Advances in technology play more of a role in shaping US inequality of income and wealth than taxes. That is one of the findings of research by **Baris Kaymak** and **Markus Poschke**, to be presented at the annual congress of the European Economic Association in Mannheim in August 2015. Their study predicts two more decades of rising wealth concentration, at the end of which the wealthiest 1% will eventually hold approximately half of total private wealth in the United States.

The researchers examine how wealth has been distributed in the United States since 1960, taking account of changes in taxes, government spending and technology. As the top 1% of wealthiest households went from owning 28% to 42% of the wealth, each of these elements changed and have been seen as responsible. The top tax rates fell (from 91% to 35%), programmes such as social security and Medicare came about and technology advances started making it far more valuable to be a skilled worker, creating a dispersion in everybody's income.

The research finds that technology accounts for two-thirds of the income inequality in the United States, as growing wage dispersion lets higher-earning workers save more of their money. By contrast, tax cuts have barely any effect, while government spending accounts for around one fifth of the inequality (where people have less need to rely on their savings for healthcare).

More...

Once an exemplar of equitable growth and middle class prosperity, the American economy is more unequal today than ever. Over the last several decades, the prosperous few claimed a growing share of the economy's riches, while the middle class stagnated. What caused this remarkable transformation and where is it taking us?

In a new study, economists Baris Kaymak (University of Montreal) and Markus Poschke (McGill University) analyse how changes in taxes, government transfers and technology shaped the evolution of the wealth distribution in the United States since 1960, with a particular focus on the share of total wealth owned by the wealthiest 1%.

They find that changes in the wage structure, which are typically attributed to new production technologies, have been the main driver of the rise in wealth concentration, accounting for two thirds of it. A fifth is attributed to more generous transfer policies, which the authors argue curbed the incentives for wealth accumulation for the middle class.

Surprisingly, they find little role for the dramatic tax cuts for top income groups, which occupied much of the political debate during this period. They also predict that wealth concentration will continue to rise for two more decades given today's wage structure and barring any future changes in tax and transfer policies.

Thanks to recent developments in measurement, we now know how dramatic the rise in wealth concentration has been. Based on their study of tax records, Emmanuel Saez and Gabriel Zucman estimate the share of wealth owned by the wealthiest 1% of tax units (a concept close but not identical to a household) to be 42% in 2012, up from 28% in 1960. Several explanations have been proposed.

Kaymak and Poschke analyse the three most prominent ones. First, over the last 50 years, the US tax system has become less progressive. In their analysis of tax records, Thomas Piketty and Emmanuel Saez report a substantial decline in taxes levied on top income groups, driven mainly by lower estate taxes and corporate income taxes. In addition, top marginal tax rates declined, from the infamous 91% in 1960 to 35% in 2010.

Second, this period saw broad expansions of transfer payments, in particular the introduction and expansion of public pensions (social security) and health insurance for the elderly (Medicare). Such policies alleviate the need to rely on personal savings for retirement.

Third, these institutional changes took place against a backdrop of technological developments that increasingly favoured highly skilled workers and resulted in higher wage dispersion. As workers save part of their earnings, this is bound to result in higher wealth dispersion.

Kaymak and Poschke find that out of these three factors, technological factors play a dominant role not only for changes in income inequality but also in wealth inequality. As high-earning households save part of their additional income, their share of wealth also rises. The expansion of transfers accounts for a fifth of the change in the top 1% wealth share, while tax cuts matter the least.

Larger transfers reduce saving incentives for retirement, in particular for low and middle-income groups. This implies that their share of private wealth declines. But this is partly due to the fact that measures of private wealth inequality, like those compiled by Saez and Zucman, do not include claims to future government transfers, like social security.

In their analysis of the wealth distribution since 1960, Kaymak and Poschke also find that wealth concentration reacts fairly slowly to changes in the economic environment. Consequently, the effect of more recent changes in fiscal policy and wage dispersion has not materialised fully yet.

The study predicts two more decades of rising wealth concentration, at the end of which the wealthiest 1% will eventually hold approximately half of total private wealth in the United States.

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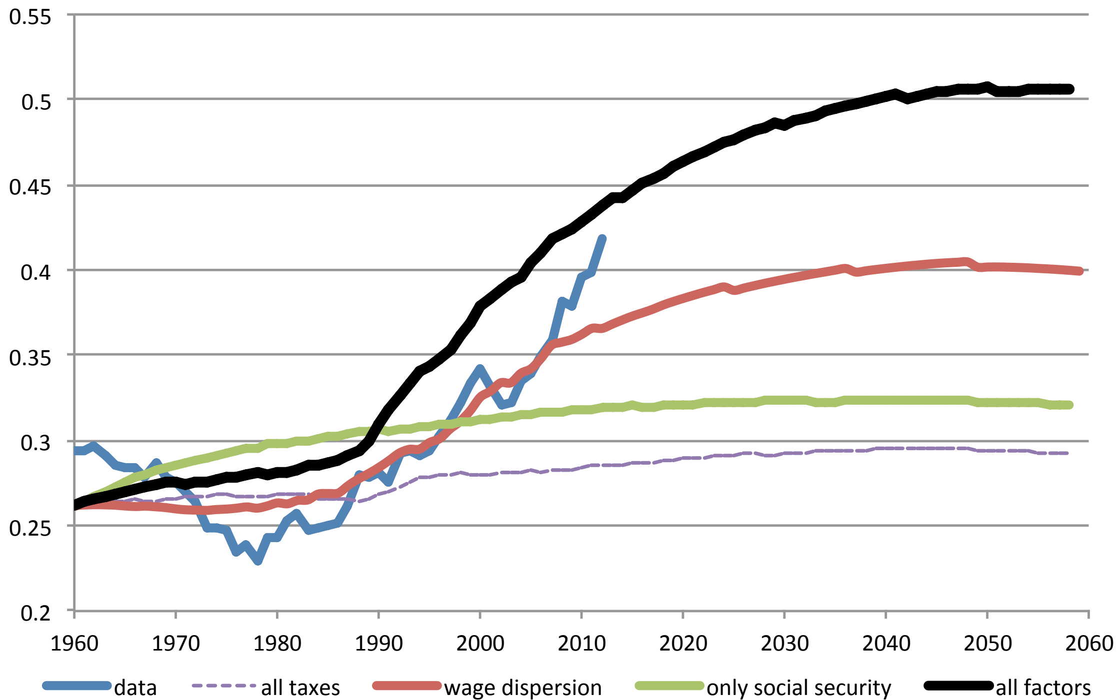

Figure 1: The evolution of the top 1% wealth share, data and model (4 scenarios)

Notes for figure:

The figure shows the evolution of the top 1% wealth share in the Saez-Zucman data (blue line) and in our model, under different assumptions (changes only in taxes, transfers, or technology, or all three at the same time). The path predicted by the model with all three channels (black line) follows the data closely except for a brief period in the 1970s, when top wealth shares declined due to falling share prices, a phenomenon that the model does not capture. The model allows us to make predictions about future wealth inequality: it keeps increasing even if wage inequality stabilises after 2000.