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Fighting Inequality Can Strengthen the US Economy

DIMITRI B. PAPADIMITRIOU, MICHALIS NIKIFOROS, and GENNARO ZEZZA

Over the last four decades, inequalities in income and wealth have grown measurably worse in the United States. As the earnings of households at the lower and middle parts of the distribution have stagnated, households at the top have reaped a greater and greater share of the rewards of economic growth. The tax cut bill that went into effect last year has only widened the gap.

Recently, Senators Elizabeth Warren and Bernie Sanders, as well as Representative Alexandria Ocasio-Cortez, proposed policies that would increase the rate of taxation on very high incomes and net worth. One of the central justifications for such policies—for slowing or potentially reversing the rise of income inequality—is motivated by concerns over the erosion of political equality. Given vanishingly few controls over political money in the United States, extreme inequalities in wealth and income can engender extreme inequalities in political influence, undermining democratic principles and institutions.

Beyond serving this broader project of democratic renewal, our research shows that such tax policies could also have a beneficial impact on the economy when paired with an equivalent rise in public spending. We simulated the effects of two policies. In the first scenario, we analyzed the impact of the wealth tax proposed by Senator Warren: an annual 2 percent tax on household net worth above $50 million, with an additional 1 percent tax on net worth above $1 billion. According to Emmanuel Saez and Gabriel Zucman, the tax would generate roughly 1 percent of GDP per year in extra revenue, after accounting for potential tax avoidance and evasion (Senator Sanders' proposed estate tax is more difficult to model due to variability in the timing of expected revenues, but it would have a similar macro effect if it raised the same amount of revenue). In the second scenario, we simulated a 10 percentage point increase in the average tax rate paid by the top 1 percent of the income distribution. After taking into account the increased disincentive to report or generate income, we estimate the tax would raise total revenues by roughly 1.3 percent of GDP. In both scenarios, which run through the period 2019–23, the revenue increases are matched by an equivalent increase in government spending. This matching assumption should not be mistaken for some form of advocacy of budget-neutral policies; rather, the assumption allows us to isolate the macroeconomic effects of redistribution. In both scenarios, we found that the overall multiplier of these policies is 1.7: a 1 percent of GDP increase in tax revenues from the richest households, paired with an equivalent increase in public spending, generates a 1.7 percent increase in GDP. In the second scenario, this translates to a 2.2 percent overall increase in GDP.

Despite this growth-boosting effect, these policies should not be considered ideal economic stimulus measures—there are far more efficient ways to increase aggregate demand. Instead, what this analysis shows is that there need be no conflict between buttressing political equality through redistributive fiscal policy and supporting the economy—quite the contrary.

Indeed, these simulations capture only a part of the likely economic benefits of raising taxes on the wealthiest households. As we have argued for several years, redressing income inequality would also address one of the US economy's deep structural weaknesses. When the income growth of households with a high propensity to consume (lower- and middle-income households) stagnates, while the majority of income growth flows to those (wealthy) households with a lower propensity to consume, overall US consumption, and therefore demand and GDP growth, is weakened. The fact that the current recovery is the slowest in the postwar era (albeit the longest-lived) is in part the result of four decades worth of income redistribution toward the top. Beyond the impact on aggregate demand, inequality may also be a factor in the slowdown of productivity growth, since the stagnation of real wages has blunted the motivation to introduce labor-saving technical advances. Moreover, income inequality plays a role in exacerbating financial fragility. The trend toward greater inequality has been accompanied by growing financialization of the economy, in terms of the ratio of total financial assets to GDP. Given the high saving rate of the richest households (the counterpart of their lower propensity to consume), rising inequality results in a significant increase in liquidity that helps drive this financialization and is a major contributing factor to financial market instability. Meanwhile, households with stagnant market earnings must turn to greater household borrowing to increase consumption, making most household balance sheets more fragile. This is part of a precarious economic structure in which (given weak net export demand and relatively strict government budgets) growth will tend to be either fragile and debt-driven (as it was in the lead-up to the 2008 crisis) or anemic (as it has been in the current recovery, with households unable or unwilling to increase their debt-financed spending).

Tax policy changes are only part of the solution to rising inequality. A more comprehensive effort would require addressing the *pretax* inequality of market income. Nevertheless, increasing the rates of taxation on very high incomes and net worth represents a first step, not just toward safeguarding political equality, but toward creating a more robust and sustainable economy.

A more detailed discussion of the issues can be found at levyinstitute.org/publications/can-redistribution-help-build-a-more-stable-economy.

DIMITRI B. PAPADIMITRIOU is president of the Levy Institute and head of the Institute's macroeconomic modeling team. MICHALIS NIKIFOROS and GENNARO ZEZZA are research scholars at the Institute.