The Role of Tax Policy in Shaping Wealth Distribution

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Economic Analysis and Documentation

Writing Sample

This writing sample analyzes the role of tax policy in shaping wealth distribution, with a focus on historical trends and policy recommendations. It demonstrates my ability to conduct detailed policy research, synthesize data, and propose actionable solutions

Tax policies, particularly the decline in progressivity since the late 1970s, have been a critical factor in shaping wealth distribution in the United States. By redistributing after-tax resources, the reduction in progressivity has notably amplified the wealth gap between societal segments, favouring wealth accumulation among the affluent. The significant drop in tax progressivity starting in the late 1970s is widely recognized as the most important driver of the increase in wealth inequality. Additionally, economic cycles have further influenced wealth concentration, with events like the Great Depression temporarily reducing wealth inequality, contrasted by economic upturns that tend to enhance wealth concentration as asset values appreciate. Swings in the returns of different asset groups have also played a vital role in these dynamics, revealing how financial markets amplify disparities. Government policy shifts in taxation and inheritance laws have directly influenced wealth distribution patterns, particularly among the top percentiles, further contributing to the increasing inequality observed over the last four decades.

The U-Shaped Wealth Distribution Trend:

The U-shaped pattern of wealth distribution in the United States since the early 1970s has drawn considerable attention from economists and policymakers alike. This phenomenon, characterized by a marked increase in wealth inequality after a period of relative stability, poses significant questions about its underlying causes and implications. Graphical data vividly illustrates this trend. For instance, the share of overall wealth held by the top 1% of households rose dramatically from around 25% in 1980 to over 40% today. Similarly, for the top 0.1%, The wealth share more than doubled over the same period. Such a steep rise indicates systemic changes in wealth dynamics and underscores the urgent need for policy interventions.

Key Factors Influencing Wealth Inequality:

Several interrelated factors contribute to this growing wealth disparity, with the following hypotheses providing insight into the mechanisms at play:

1. **Labour Income Distribution:**

   The distribution of labour income plays a significant role in wealth inequality. An outsized proportion of earnings accruing to the top 0.1% of earners significantly skews wealth distribution. Visualized in data, this trend shows the escalating share of income among the elite, further marginalizing the lower and middle-income groups. As wage growth stagnates for the majority while surging for the top earners, the divide in wealth accumulation becomes more pronounced.

2. **Tax Code Progressivity:**

The diminishing progressivity of tax rates over time has facilitated wealth accumulation at the top, widening the inequality gap. Historical tax policies that once redistributed wealth effectively have eroded, allowing high-income earners to retain larger portions of their wealth. Data reveals that changes in top marginal tax rates have had a significant impact on the wealth of the top percentiles, making this one of the most critical drivers of inequality.

3. **Earnings Risk:**

Increased unpredictability in earnings particularly impacts lower-income groups, exacerbating the wealth divide. Those with volatile incomes are less able to save or invest, limiting their opportunities for wealth accumulation. This risk often stabilizes wealth for the top earners, who have diversified income sources and financial buffers, while destabilizing those with fewer resources.

4. **Returns on Private Equity Investments:**

Substantial returns from private equity investments disproportionately concentrate wealth among the already affluent. The ability to generate higher returns on capital through these avenues remains out of reach for the majority, exacerbating existing disparities. These investments have become a mechanism through which wealth begets wealth, perpetuating economic dominance among the top percentiles.

Analytical Framework and Findings:

The interplay of these factors is captured in the model, which highlights the growing disparity in earnings inequality as labour income and investment decisions diverge (Equation 6). This divergence results in unequal opportunities for wealth accumulation among different social groups. Adding to this inequality is the fact that variable investment returns (Equation 7) disproportionately benefit those who already possess significant wealth, further deepening the socioeconomic divide.

The progressivity of the tax system (Equation 5) emerges as a pivotal factor, where less progressive taxes contribute to a steeper wealth pyramid. Additionally, consumer financial behaviour (Equation 4) demonstrates how resource allocation choices, influenced by income levels and potential investment returns, further shape wealth distribution dynamics. Together, these factors create a feedback loop in which disparities in labour income, capital returns, and tax policies interact with individual economic behaviours to either reinforce or reduce wealth inequality.

Graphical analyses, such as Figure 1, reinforce these findings. The figure shows the wealth concentration among the top 1% rising dramatically, driven by tax changes and economic cycles. Meanwhile, Figure 5 highlights the escalating share of income accruing to top earners, showcasing the stark disparities that underpin wealth inequality.

Policy Implications and Recommendations:

The findings of this analysis reveal an urgent need for significant policy interventions, particularly in the realm of tax progressivity. Historical comparisons between countries like Sweden and the United States underscore this point. Sweden's commitment to equitable wealth distribution through higher marginal tax rates (up to 76%) has led to consistent top rankings for income equality. In contrast, the United States, with its lower top marginal tax rates, exhibits greater wealth inequality and a lower global equality ranking.

Implementing progressive tax reforms, such as higher marginal rates for top earners and strengthened estate taxes, could help mitigate the widening wealth gap. By redistributing wealth more effectively, such measures would provide the necessary resources for public services and social programs, directly benefiting lower and middle-income groups.

Additionally, policies that target investment returns, such as capital gains tax adjustments, could help reduce the disproportionate advantage enjoyed by affluent individuals. Encouraging broader
access to investment opportunities, coupled with protections against earnings risk for lower-income groups, would further level the playing field.

Broader Implications for Wealth and Society:

The broader implications of wealth inequality extend beyond economic disparities. Persistent inequality undermines social cohesion, hampers economic mobility, and fosters discontent among marginalized groups. The historical U-shaped trend, which has re-emerged in the modern era, serves as a stark reminder of the cyclical nature of inequality and the necessity of proactive governance to address it.

The comparative analysis between Sweden and the U.S. highlights the effectiveness of comprehensive social welfare systems in narrowing income disparities. Sweden's Nordic model, with its dual-income tax system and universal benefits, provides a blueprint for addressing inequality while fostering economic stability. Implementing similar frameworks in the U.S., tailored to its unique economic and political context, could significantly alleviate wealth disparities.

Conclusion:

This analysis underscores the critical role of tax policy in shaping wealth distribution dynamics. The decline in progressivity, combined with varying asset returns and systemic disparities in labour income, has driven the U-shaped trend in wealth inequality observed over the last four decades. By addressing these factors through targeted reforms, policymakers have an opportunity to reverse these trends and foster a more equitable society.

Reducing the wealth gap is not merely a matter of fairness but a necessity for long-term economic and social stability. Tax progressivity, enhanced investment accessibility, and protections against earnings risk emerge as key levers for change. The U.S. must prioritize these measures to address the growing wealth divide, drawing on lessons from successful models like Sweden's. In doing so, the nation can create a foundation for sustainable growth, shared prosperity, and social harmony.

Citations:

Hubmer, J., Krusell, P., & Smith., A. A. (2021). Sources of us wealth inequality: Past, present, and future. Macroeconomics Annual, 35, 391–455. https://doi.org/10.1086/712332

Appendix:

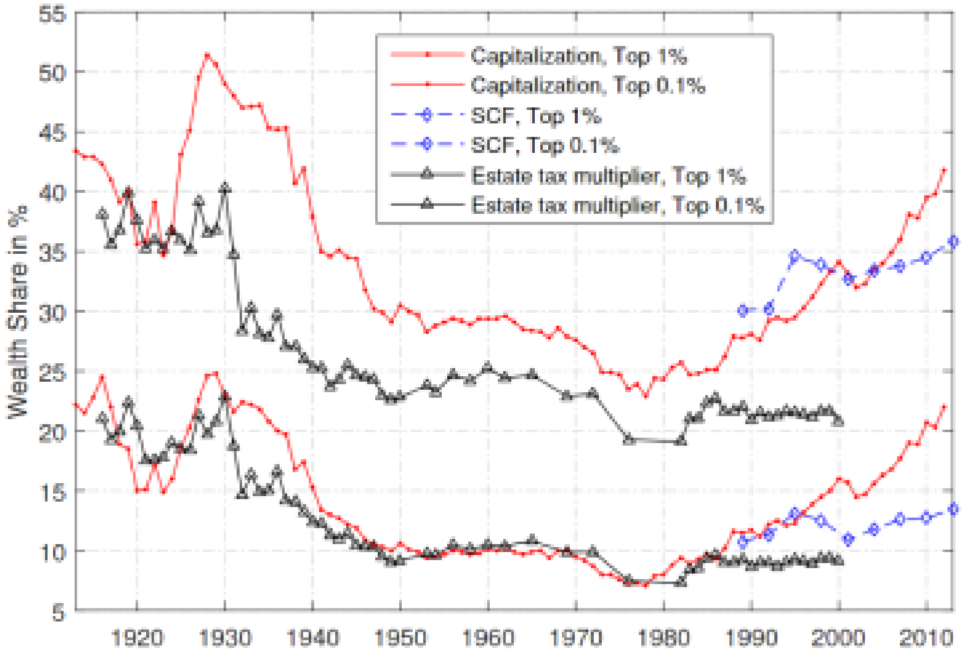


Figure 1: Top wealth share measurements over time

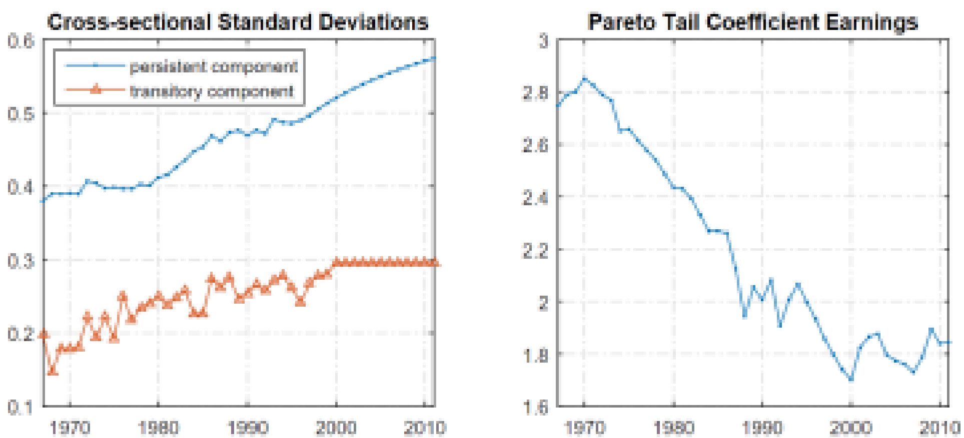


Figure 4: Earnings process ingredients

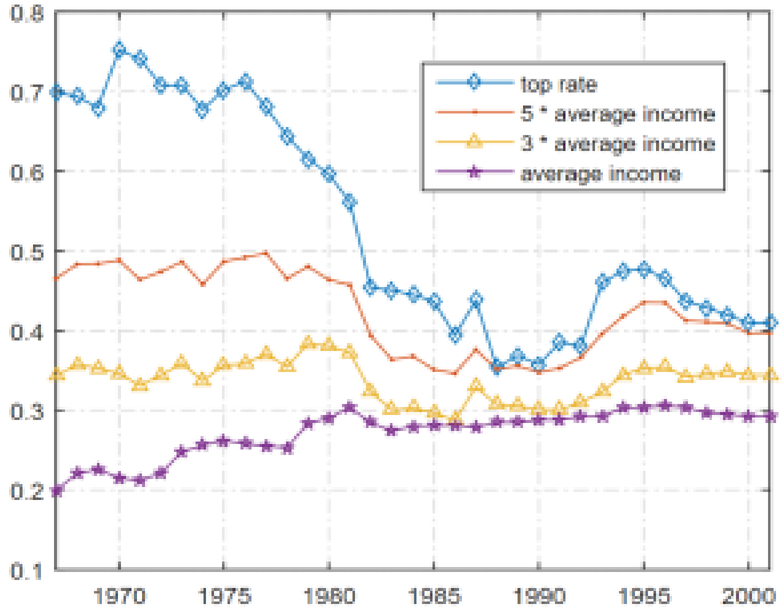


Figure 6: Imputed marginal tax rates for selected total income levels

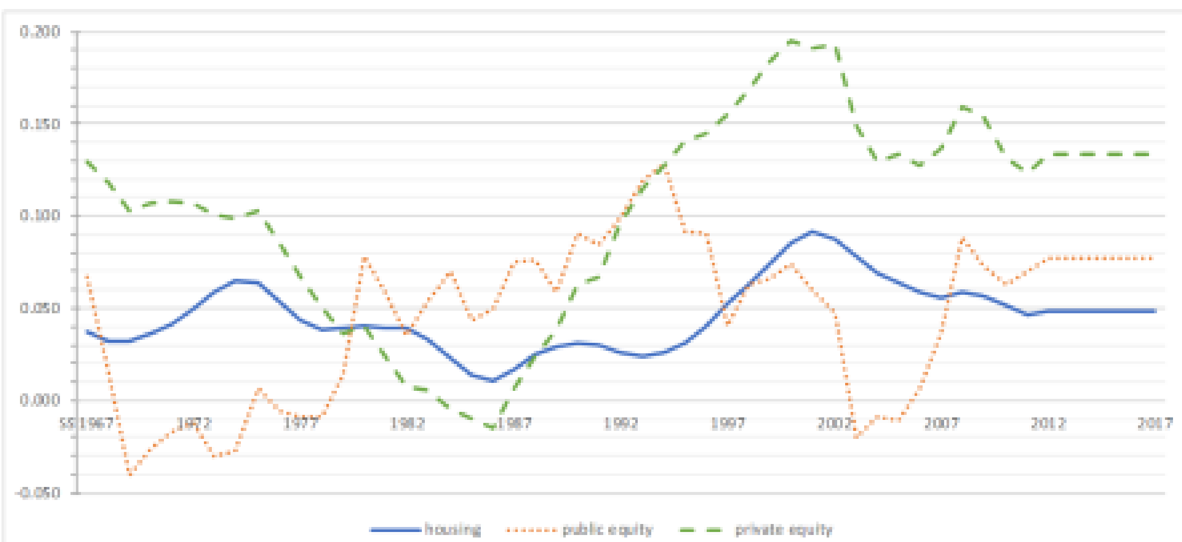


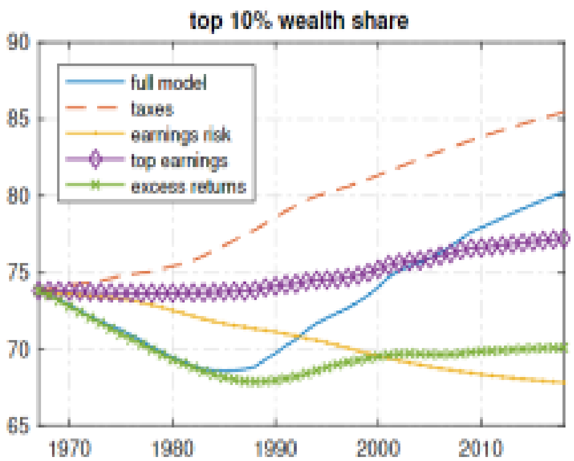
Figure 8: Aggregate excess returns

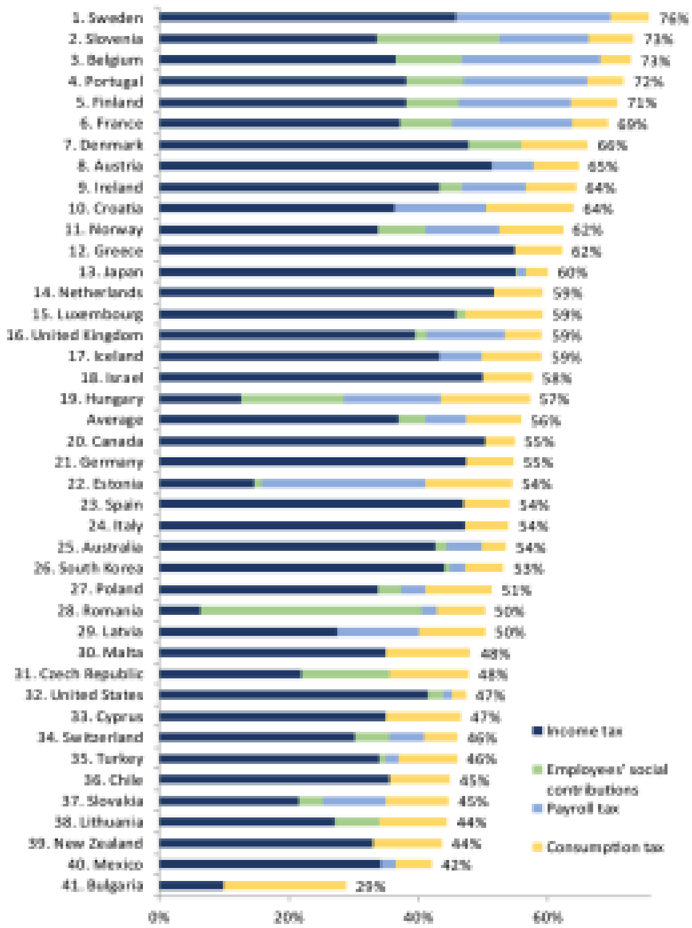
$$V_t(x_t, p_t, \beta_t) = \max_{a_{t+1} \geq \underline{a}} \left\{ u(x_t - a_{t+1}) + \beta_t \mathbb{E}\left[V_{t+1}(x_{t+1}, p_{t+1}, \beta_{t+1}) | p_t, \beta_t \right] \right\} \tag{4}$$

$$\text{subject to } x_{t+1} = a_{t+1} + y_{t+1} - \tau_{t+1}(y_{t+1}) + (1 - \tilde{\tau}_{t+1})\tilde{y}_{t+1} + T_{t+1} \tag{5}$$

$$y_{t+1} = \left(\underline{r}_{t+1} + r^X_{t+1}(a_{t+1}) \right) a_{t+1} + w_{t+1} l_{t+1}(p_{t+1}, \nu_{t+1}) \tag{6}$$

$$\tilde{y}_{t+1} = \sigma^X(a_{t+1}) \eta_{t+1} a_{t+1} \tag{7}$$


top 10% wealth share
full model
taxes
earnings risk
top earnings
excess returns
90
85
80
75
70
65
1970
1980
1990
2000
2010


1. Sweden 76%
2. Slovenia 73%
3. Belgium 73%
4. Portugal 72%
5. Finland 71%
6. France 69%
7. Denmark 66%
8. Austria 65%
9. Ireland 64%
10. Croatia 64%
11. Norway 62%
12. Greece 62%
13. Japan 60%
14. Netherlands 59%
15. Luxembourg 59%
16. United Kingdom 59%
17. Iceland 59%
18. Israel 58%
19. Hungary 57%
Average 56%
20. Canada 55%
21. Germany 55%
22. Estonia 54%
23. Spain 54%
24. Italy 54%
25. Australia 54%
26. South Korea 53%
27. Poland 51%
28. Romania 50%
29. Latvia 50%
30. Malta 48%
31. Czech Republic 48%
32. United States 47%
33. Cyprus 47%
34. Switzerland 46%
35. Turkey 46%
36. Chile 45%
37. Slovakia 45%
38. Lithuania 44%
39. New Zealand 44%
40. Mexico 42%
41. Bulgaria 29%
Income tax
Employees' social contributions
Payroll tax
Consumption tax
0%
20%
40%
60%

Country	Global Rank	World Economics Inequality Index (0-100)	World Economics Inequality Grade: A-E
Slovak Republic	1	100.0	A
Slovenia	2	98.1	A
Belarus	3	97.2	A
Ukraine	4	94.5	A
Moldova	5	94.2	A
Belgium	6	92.2	A
Denmark	7	91.2	A
Finland	8	90.2	A
Norway	9	90.0	A
Netherlands	10	89.5	A
Armenia	11	89.2	A
Hungary	12	88.3	A
Korea, Rep.	13	86.6	A
Sweden	14	86.4	A