The Economic Consequences of Major Tax Cuts For the Rich

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LSE III
Inequalities Seminar Series
February 2, 2021

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Tax Cuts for the Rich

- A summary of our findings in Twitter memes:
Tax Cuts for the Rich

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[Image of a Twitter post by @ProsinPlanet with a screenshot of a Bloomberg Wealth article titled "Fifty Years of Tax Cuts for Rich Didn’t Trickle Down, Study Says"]

7:48 · 17 Dec 20 · Twitter for Android

4,013 Retweets 62 Quote Tweets 29.7K Likes
Tax Cuts for the Rich

- A summary of our findings in Twitter memes:

Amy, 2022 Mothman Festival Queen
@cableknitjumper

Bloomberg Wealth
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Taxes
Fifty Years of Tax Cuts for Rich Didn’t Trickle Down, Study Says
By Craig Stirling
15 December 2020, 16:01 GMT-8

- Paper looks at fiscal policies in 18 countries over 50 years
- Governments shouldn’t worry about taxes on rich, author says

5:52 PM · Dec 16, 2020 · Twitter for Android

23.4K Retweets 1.5K Quote Tweets 163.3K Likes
In fact, the discussion over the impact of tax structure on economic development dates back long in time. Assumption of steeply progressive tax systems as a drag on economic growth became widespread from the 1970s onwards (see Steinmo (1993) for an overview). Public finance scholars of the first half of the 20th century saw progressive taxation as economically superior (e.g. Edwin Seligman, Carl Shoup, Nicholas Kaldor). However much Ministers may try to revive incentives through tax reductions, they can never hope to achieve the Victorian or Edwardian peaks in fiscal incentives, when income tax was not progressive and it was seven old pence in the pound or 3 percent instead of the present 33 percent. Yet with all those incentives, the economy was stagnating.
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Nicholas Kaldor 1983, p. 9

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Our Study

Research Question
What are the economic effects of major tax cuts for the rich?
Previous Work

Existing macro-level studies mostly provide correlational evidence. Whilst some studies find that higher tax progressivity is correlated with lower growth (Gemmell et al., 2014), most studies find no significant association (Angelopoulos et al., 2007; Lee and Gordon, 2005; Piketty et al., 2014).

A number of studies find lower top marginal income tax rates are associated with higher top 1% income shares (Huber et al., 2019; Piketty et al., 2014; Roine et al., 2009).

Three limitations:

1) Most studies look at single taxes and indicators (e.g. top marginal income tax rates).
2) Hard to make causal claims with observational data (and political science literature tells us reverse causality likely to be an issue).
3) Existing causal evidence limited to effects of single tax reforms (Rubolino and Waldenström, 2020).
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Measuring Taxes on the Rich

We propose a comprehensive approach constructing a new indicator that measures taxes on the rich across countries and over time. Bayesian latent variable modelling (Merkle and Rosseel, 2018). Models were run with normal diffuse priors, three Markov-Chain-Monte-Carlo chains and 1000 burnin iterations.

Indicators:

- Top Incomes: Top marginal income tax rates, tax burden on the top 1% of wage earners.
- Capital: Statutory corporate income tax rate, top marginal tax rate on dividends, effective average tax rate on capital.
- Assets: Top inheritance tax rate, tax revenue from assets (inheritance/estates/net wealth/immovable property, as % of GDP).

Advantage: Robust to missing values for some indicators.
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Our Comprehensive Measure of Taxes on the Rich

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Year

Identifying Major Tax Cuts for the Rich

We then use this indicator to identify major tax cuts for the rich. We code major tax cuts as years in which the index fell by over 2 standard deviations. Threshold often used in empirical literature in macroeconomics (Dell’Erba et al., 2015; Fernández-Villaverde et al., 2015) – but we use 1 standard deviation as an alternative threshold as well.
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Major Tax Cuts for the Rich in the OECD Since 1965

2 Standard Deviations Threshold

Year:
- United States
- United Kingdom
- Sweden
- New Zealand
- Italy
- Netherlands
- Germany
- Canada
- Australia
- Norway
- Japan
- Ireland
- Finland
- Denmark
- Belgium
- Austria
- Switzerland
- France

Major Tax Cuts for the Rich in the OECD Since 1965

1 Standard Deviation Threshold

Year

Empirical Strategy

Most countries cut taxes on the rich substantially. Hence, focusing on effects of single reforms might be misleading. We utilise a new method for causal inference in observational studies, which uses a generalization of the difference-in-differences estimator that implements Mahalanobis distance matching in panel data analysis (Imai et al., 2020).

Three main ideas:
1) We compare countries (with similar pre-treatment treatment trajectories) that cut taxes on the rich to those that didn’t in a given time period. We repeat this for all major reforms.
2) We calculate the difference-in-differences estimator for different lags and leads. Lags allow us to estimate the development of the effect over time. Leads allow us to check whether the parallel trends assumption holds.
3) We use Mahalanobis distance matching to compare countries with similar covariate trajectories.
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Data

Three main dependent variables:

- Effects of tax cuts for the rich on inequality (top 1% income shares (Alvaredo et al., 2018))
- Effects of tax cuts for the rich on economic growth (Real GDP pc in 2011 US Dollars, logged values (Feenstra et al., 2015))
- Effects of tax cuts for the rich on unemployment (harmonised unemployment rates (OECD, 2020a))

Battery of time-varying variables to match upon – e.g. capital account openness (Chinn and Ito, 2006), left vote share in last election (Brady et al., 2020), government expenditure as % of GDP (OECD, 2019).

Block-bootstrap procedure to calculate standard errors (Imai et al., 2020).
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Results
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Inequality

Effect on Top 1% Income Share

Years Relative to Tax Cut

-5 -4 -3 -2 -1 0 1 2 3 4 5

-1 0 1
Results

Unemployment

Effect on Unemployment Rate

Years Relative to Tax Cut

Effect on Unemployment Rate
Results

Inequality (1SD Threshold)

Effect on Top 1% Income Share

Years Relative to Tax Cut
Results

Growth (1SD Threshold)

Effect on GDP pc (log)

-0.050
-0.025
0.000
0.025

Years Relative to Tax Cut

-5 -4 -3 -2 -1 0 1 2 3 4 5
Results

Unemployment (1SD Threshold)

Effect on Unemployment Rate

Years Relative to Tax Cut
Conclusions

In sum, major tax cuts on the rich do not boost the economy. Growth and unemployment is neither statistically nor substantively significantly different after tax cuts for the rich.

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- Growth and unemployment is neither statistically nor substantively significantly different after tax cuts for the rich.
- Main effect: Inequality increases.
Future research

Further differentiation possible:
- Differences between tax cuts on personal income, corporate profits, and wealth?
- Effect heterogeneity? Differ with national institutions?
- Effects outside the OECD?

Our study adds to evidence that ‘trickle-down’ policies are ineffective macroeconomic tools.

However, the idea of such ‘trickle-down’ effects persists – why?

Survey experiments to shed light on this question – we are currently in the design phase.

Potential book project on ‘The Trickle-Down Myth’.
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