Redistribution and Investment

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September 2023

Abstract

This paper studies the trade-offs associated with income redistribution in an overlapping generations model in which savings rates increase with permanent income. By transferring resources from high savers to low savers, redistribution lowers aggregate savings, and depresses investment. I derive sufficient conditions under which this non-homothetic savings behavior generates a welfare trade-off between lump-sum redistribution and capital accumulation in the short and long run. I quantify the size of this trade-off in two ways. First, I derive a sufficient statistic formula for the impact of this channel on welfare, and estimate the formula using U.S. household panel data. When redistribution is done with a labor income tax, the welfare costs associated with my channel are between 1/4 and 1/2 the size of those associated with labor supply distortions. Second, I solve a pre-cautionary savings overlapping generations model with non-homothetic savings behavior. Again I find that the welfare impact of my channel is around 1/2 the size of the impact of distorted labor supply, but that the interaction of the two channels has a dampening effect.

Keywords: Redistribution, Non-Homothetic Preferences, Optimal Capital Accumulation, Sufficient Statistics
JEL codes: E21, E22, H21, D63

[*]I would like to thank Jennifer La'O and Émilien Gouin-Bonenfant for their continuous support and excellent feedback. I would like to also thank Hassan Afrouzi, Stephen Zeldes, and seminar participants at Columbia University for many helpful conversations.

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