'Trickle-down' theory doesn't hold up

by Robert H. Frank

WHEN ASKED why he robbed banks, Willie Sutton famously replied, "Because that's where the money is." The same logic explains the call by John Edwards, the Democratic Party's presidential candidate, for higher taxes on top earners to underwrite his proposal for universal health coverage.

Providing universal coverage will be expensive. With the median wage, adjusted for inflation, lower now than in 1980, most middle-class families cannot afford additional taxes. In contrast, the top tenth of one per cent of earners today make about four times as much as in 1980, while those higher

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up have enjoyed even larger gains. Top earners are where the money is. Universal health coverage cannot happen unless they pay higher taxes.

Trickle-down theorists are quick to object that higher taxes would cause top earners to work less and take fewer risks, thereby stifling economic growth. The surface plausibility of trickle-down theory owes much to the fact that it appears to follow from the time-honoured belief that people respond to incentives. Because higher taxes on top earners reduce the reward for effort, it seems reasonable that they would induce people to work less. On close examination, however, this claim is supported neither by economic theory nor by empirical evidence.

As every economics textbook makes clear, however, a decline in after-tax wages also exerts a second, opposing effect. By making people feel poorer, it provides them with an incentive to recoup their income loss by working harder than before.

Brutal lessons of experience

If lower real wages induce people to work shorter hours, then the opposite should be true when real wages increase. Then, the cumulative effect of the last century's sharp rise in real wages should have been a significant increase in hours worked. However, the workweek is much shorter now than in 1900.

This theory also predicts shorter workweeks in countries with lower real after-tax pay rates. Yet here, too, the numbers tell a different story. For example, even though chief executives in Japan earn less than one-fifth what their American counterparts do and face substantially higher marginal tax rates, Japanese executives do not log shorter hours.

Inequality and growth

Trickle-down theory also predicts a positive correlation between inequality and economic growth, the idea being that income disparities strengthen motivation to get ahead. Yet when researchers track the data within individual countries over time, they find a negative correlation. In the decades immediately after the Second World War, for example, income inequality was low by historical standards, yet growth rates in most industrial countries were extremely high. In contrast, growth rates have been only about half as large in the years since 1973, a period in which inequality has been steadily rising.

The same pattern has been observed in cross-national data. For example, using data from the World Bank and the Organization for Economic Cooperation and Development (OECD) for a sample of 65 industrial nations, the economists Alberto Alesina and Dani Rodrick found lower growth rates in countries where higher shares of national income went to the top five per cent and the top 20 per cent of earners.

In contrast, larger shares for poor and middle-income groups were associated with higher growth rates. Again and again, the observed pattern is the opposite of the one predicted by trickle-down theory.

In the United States, trickle-down theory's insistence that a more progressive tax structure would compromise economic growth has long blocked attempts to provide valued public services. Although every other industrial country provides universal health coverage, these theorists insist that the wealthiest country on earth cannot afford to do so.

Low and middle-income families are not the only ones who have been harmed by our inability to provide valued public services. Many top earners would willingly pay higher taxes for public services that promise high value. This theory, which is supported neither by theory nor evidence, is ripe for abandonment.

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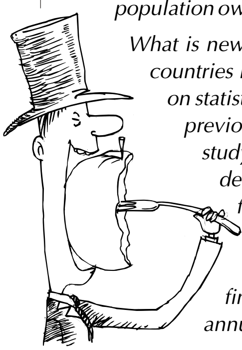
Richest 2% own 'half the wealth' *by Andrew Walker*

The richest 2% of adults in the world own more than half of all household wealth, according to a new study by a United Nations research institute. The report, from the World Institute for Development Economics Research at the UN University, says that the poorer half of the world's population own barely 1% of global wealth.



What is new about this report is its coverage. It deals with all countries in the world - either actual data or estimates based on statistical analysis - and it deals with wealth, where most previous research has looked at income. Wealth in this study is what people own, less what they owe - their debts. The assets include land, buildings, animals and financial assets.

The analysis shows striking divergences in wealth and in types of assets between countries. It also finds that inequality is sharper in wealth than in annual income.

Why does it matter? Because wealth serves as insurance against times when incomes tend to fall: such as unemployment, sickness or old age. It is also a source of finance for small businesses, a particularly important point since it is the countries with lower levels of personal wealth which also tend to have weaker financial systems without the funds, ability or inclination to lend to small firms.

The report is not about policy recommendations. But it does draw attention to the importance of enhancing banking systems in developing countries to help generate the funds for business investment.

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http://news.bbc.co.uk/2/hi/business/6211250.stm
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