The New York Times
nytimes.com

April 12, 2007

ECONOMIC SCENE

In the Real World of Work and Wages, Trickle-Down Theories Don'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 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 1 percent of earners today make about four times as much as in 1980, while those higher up have enjoyed even larger gains. Chief executives of large American companies, for example, earn more than 10 times what they did in 1980. In short, 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. In their familiar rhetorical flourish, they insist that a more progressive tax system would kill the geese that lay the golden eggs. On close examination, however, this claim is supported neither by economic theory nor by empirical evidence.

The surface plausibility of trickle-down theory owes much to the fact that it appears to follow from the time-honored 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, as trickle-down theorists claim. 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. Economic theory says nothing about which of these offsetting effects may dominate.

If economic theory is unkind to trickle-down proponents, the lessons of experience are downright brutal. If lower real wages induce people to work shorter hours, then the opposite should be true when real wages increase. According to trickle-down theory, then, the cumulative effect of the last century's sharp rise in real wages should have been a significant increase in hours worked. In fact, however, the workweek is much shorter now than in 1900.

Trickle-down 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.

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 World War II, 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 Co-operation and Development 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 5 percent and the top 20 percent 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.

The trickle-down theorist's view of the world is nicely captured by a Donald Reilly cartoon depicting two well-fed executives nursing cocktails on a summer afternoon as they lounge on flotation devices in a pool. Pointing to himself, one says angrily to the other, "If those soak-the-rich birds get their way, I can tell you here's one coolie who'll stop" working so hard.

This portrait bears little resemblance to reality. In the 1950s, American executives earned far lower salaries and faced substantially higher marginal tax rates than they do today. Yet most of them competed energetically for higher rungs on the corporate ladder. The claim that slightly higher tax rates would cause today's executives to abandon that quest is simply not credible.

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. Thus, although every other industrial country provides universal health coverage, trickle-down theorists insist that the wealthiest country on earth cannot afford to do so. Elizabeth Edwards faces her battle with cancer with the full support of the world's most advanced medical system, yet millions of other Americans face similar battles without even minimal access to that system.

Low- and middle-income families are not the only ones who have been harmed by our inability to provide valued public services. For example, rich and poor alike would benefit from an expansion of the Energy Department's program to secure stockpiles of nuclear materials that remain poorly guarded in the former Soviet Union. Instead, the Bush administration has cut this program, even as terrorists actively seek to acquire nuclear weaponry.

The rich are where the money is. Many top earners would willingly pay higher taxes for public services that promise high value. Yet trickle-down theory, which is supported neither by theory nor evidence, continues to stand in the way. This theory is ripe for abandonment.

Robert H. Frank, an economist at the Johnson School of Management at Cornell University, is the author of "The Economic Naturalist," which will be published next month. Contact: www.robert-h-frank.com.