Center for American Progress

Trickle-Down Economics and Broken Promises

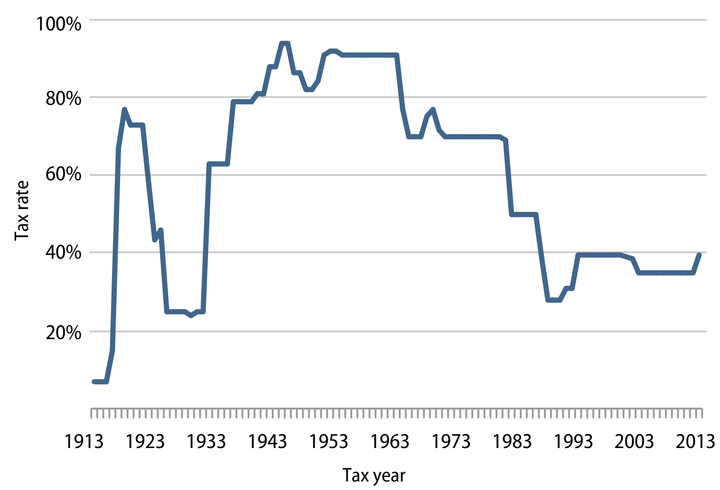
How Inequality Is Holding Back Our Economy

By Ben Olinsky and Asher Mayerson December 4, 2013

For more than 30 years, conservative politicians have tried to sell Americans on the notion that giving tax cuts to the wealthy will spur economic growth and job creation, generating broad-based economic prosperity. Their marketing of this "trickle-down economics" has been successful: After decades of campaigning, many Americans now accept the oft-repeated assertion that lower taxes and less regulation leads to job growth. Congress followed suit, lowering tax rates sharply for the highest-income earners, while leaving tax rates relatively unchanged for other groups. When President Ronald Reagan took office in 1981, the marginal tax rate for the highest income bracket was 70 percent, but that fell to just 28 percent by the time he left office.[1] Even after modest increases since then, the top marginal tax rate for top earners today hovers at just more than half of what it was in 1980 (see figure 1). At the same time, Congress and the courts have taken repeated steps to roll back labor and financial regulation, further contributing to the skyrocketing wealth of the top 1 percent.

FIGURE 1

Top marginal tax rate



Source: Tax Policy Center, "Tax Facts: Historical Individual Income Tax Parameters," available at http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=543 (last accessed October 2013).

Yet empirical economic data show that these misguided policies did not deliver on their promises, as our nation's economy after the tax increases of 1993 significantly outperformed the periods after tax cuts in the 1980s and 2000s. Investment growth, productivity growth, employment growth, middle-class income growth, national fiscal health, and overall economic growth were weaker or declined under trickle-down policies.[2]

Far from generating broad prosperity, these misguided policies have also led to an unprecedented level of income inequality in the United States. Conservatives have alternately denied a rise in inequality outright or insisted on its necessity for optimal growth. In 2012, for example, conservative columnist and political commentator Michael Tanner wrote that "inequality may not be growing at all.[3]

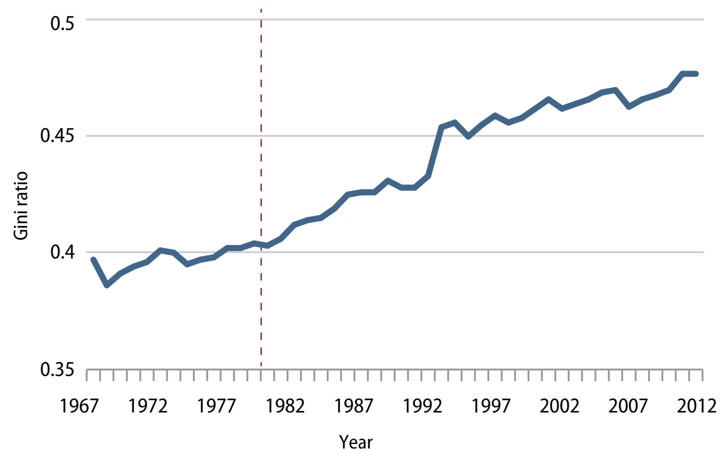
Economist Diana Furchtgott-Roth goes even further in writing about the "myth of increasing income inequality," concluding that "inequality has declined rather than increased."[4] But a preponderance of economic research—and the real-world experiences of millions of Americans who witness rising inequality firsthand—show this to be untrue. The Gini index, economists' well-tested measure of inequality and one the U.S. Census Bureau officially calculated, shows that the United States has seen a steady rise in income inequality since 1980 (see figure 2).[5]

Other conservatives acknowledge that inequality may be rising but claim that it is a positive development that provides Americans with strong incentives to work hard and innovate. This is what led Richard Epstein, a senior fellow at the Hoover Institution, to pen the column "In Praise of Income Inequality," in which he takes aim at "increased regulation and taxation" as holding back equitable growth.[6] According to trickle-down theory, cutting the top marginal tax rate should generate the larger incentives needed for stronger economic growth, even if doing so also drives up inequality. But in reality, our nation saw its highest growth rates not when the top marginal tax rate was 28 percent, but when it was 75 percent to 80 percent (see figure 3).

Of course, this comparison does not take into account tremendous structural differences in the economy over these periods, and there has been a long and robust debate among economists on the effects of inequality on economic growth—dating back to Adam Smith's acknowledgement of both the costs and benefits of inequality. Yale University economist Arthur Okun set the contours of the modern debate with his 1975 book, *Equality and Efficiency: The Big Tradeoff*, which argued that greater income inequality offers more rewards for work and investment, and hence income inequality and economic efficiency are in tension.[7]

FIGURE 2

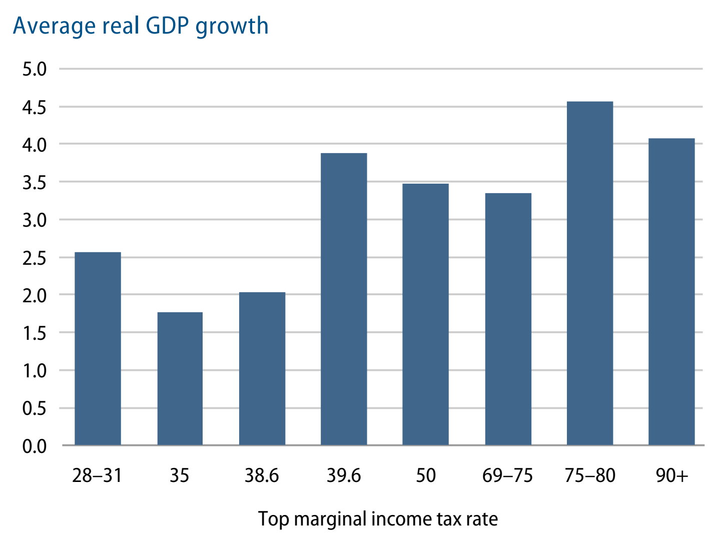
Gini index for U.S. households



Source: U.S. Census Bureau, "Table H-4: Gini Ratios for Households, by Race and Hispanic Origin of Householder," available at http://www.census.gov/hhes/www/income/data/historical/inequality/ (last accessed October 2013).

FIGURE 3

Average annual growth in real gross domestic product, by top marginal tax rate, 1950-2010



Source: Bureau of Economic Analysis and Tax Policy Center.

Empirical research since then has been mixed, but much of it conflicts with Okun's hypothesis and suggests that inequality hurts long-term economic growth. A 1996 effort by economist Roland Benabou to summarize the research found that 11 of the 23 studies surveyed showed that inequality strongly negatively impacted growth, while the remaining 12 studies showed a negative but questionably significant impact or no effect at all.[8] Still, some economists such as Robert Barro have put forward a more nuanced view in which the impact of inequality on growth may not be a simple linear relationship; for example, it may be bad for growth in poor countries and good for growth in rich countries.[9] Others have interpreted Barro's results to indicate that higher inequality may increase growth in the short run but hurt it in the long run.[10] Studies looking at the relationship between inequality and growth only in the United States have typically found either a clear negative relationship or a positive relationship in the short run and a negative one in the long run.[11] While the short-term relationship may be more in question, there is evidence that in the long run, inequality can hold back an economy.

Three new papers commissioned by the Center for American Progress shed fresh light on this debate, offering convincing evidence that higher inequality does not in fact lead to growth and may actually hold back our economy:

- David Howell, a professor of economics and public policy at The New School, details our country's growing income inequality since 1980 and contrasts two broad visions: a "laissez-faire" story in which high and rising inequality invariably promotes economic performance; and a "political economy" vision in which rising inequality—over a certain modest threshold—harms growth and middle-class welfare. In comparisons of the United States with other high-income countries, he shows that America's extreme inequality of the past three decades has not produced exceptional growth performance; that across countries, higher inequality has if anything been associated with slower growth; and that the United States has the worst record in the rich world for sharing its productivity growth with nonsupervisory workers.

- Jared Bernstein, a senior fellow at the Center on Budget and Policy Priorities, develops human capital and political economy models that demonstrate the possible mechanisms through which income inequality can slow down growth rates.

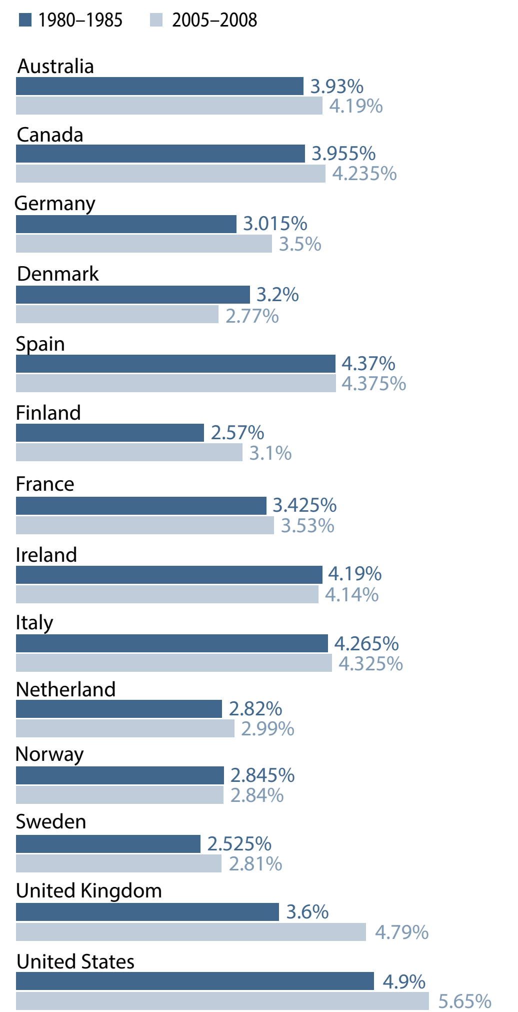
- Adriana Kugler, a professor of public policy at Georgetown University, analyzes how economic policy and social services can contribute to a healthy labor market. She demonstrates that these policies that are designed to fight inequality also lead to a more productive use of human capital, which we know from previous research lead us to a stronger economy.

Taken together, these three new reports significantly contribute to this debate and offer convincing evidence that undermines the trickle-down-theory assertion that inequality is a necessary condition of growth. Instead, they help us understand that our nation's rising level of inequality is holding back our economic potential and must be addressed to improve our prosperity. The remainder of this issue brief further summarizes and details their findings.

As the nation struggles to recover from the deepest recession in generations, policymakers are now faced with a stark choice: continue the trickle-down policies that have dominated much of the past three decades—and the lackluster growth and high inequality that results from it—or change direction and focus on growing the economy from the "middle out" instead of from the top down. This choice is at the heart of every major economic debate now before us. Should we raise or lower taxes on the wealthy? Should we cut spending or make strategic investments in education, research, and infrastructure? Should we raise the minimum wage or abolish it entirely? Should we effectively regulate financial markets or allow the free market to sort itself out? Only when we acknowledge that trickle-down economic policies and its resulting inequality are holding back our economy will we be able to bolster and grow the middle class, create more economic demand, and unleash 300 million individual engines of growth.

FIGURE 4

The 90-10 ratio of household disposable monetary income (per household member) for 14 high-income countries



Source: Author's calculations are based on data from the Luxembourg Income Study, or LIS, Database. The specifications are the same as in figure 3. The values denominate the income ratio between the 90th percentile and 10th percentile of the distribution.

'The Great Laissez-Faire Experiment: American Inequality and Growth from an International Perspective'

David Howell's report[12] details the rise in income inequality in the United States and the policies that led us to the wealth disparities we see today. Howell asks a question at the heart of trickle-down theory: Have the policies that generated immense inequality led to greater growth? His empirical findings demonstrate that inequality has not produced strong economic growth by the standards of other affluent countries and that we share less of our productivity growth with nonsupervisory workers than any other rich country.

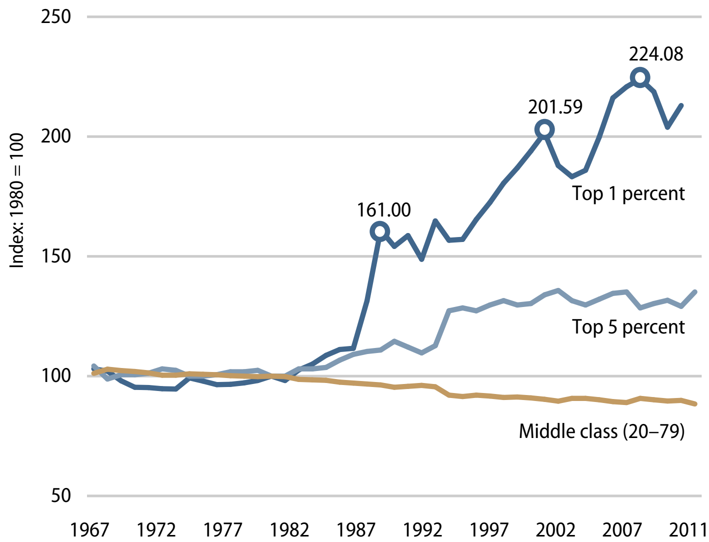
Howell begins by making the case that inequality has undeniably grown over the past few decades. In that span of time, the incomes of Americans at the top of the income distribution have risen considerably more than the wages of those in the middle and at the bottom, making the United States the fourth-highest-ranking country on income inequality in the Organisation for Economic Co-operation and Development, or OECD, trailing only Chile, Mexico, and Turkey.[13]

Among the countries included in Howell's study, the United States ranks highest in income inequality on all three inequality indicators he uses. On the 90-10 ratio—the income received at the 90th percentile to the 10th percentile of the income distribution—there was a noticeable rise in U.S. inequality over time, with the ratio rising from 4.9 during the period from 1980 to 1985 to 5.65 during the period from 2005 to 2008 (see figure 4).

Figure 5, reproduced from Howell's paper, tracks the share of national income held by the top 1 percent, 5 percent, and middle 60 percent since 1967. It is clear that those shares were stable from 1967 to 1980 but changed abruptly so that from 1980 to 2006, the middle 60 percent's share fell by 11 percent, the top 5 percent's share rose by 35 percent, and the top 1 percent's share rose by 120 percent.

FIGURE 5

Top 1 percent, top 5 percent, and middle 60 percent of total income, 1967–2011



Source: For the series, U.S. Census Bureau, "Top 5 Percent and the Middle Class, 2012," Table H-2. The top 1 percent series is taken from the World Top Incomes Database, or WTID. All three series are indexed to 100 in 1980.

Ideological shifts and the increasing power of a wealthy few have led government policy to put the interests of the financial sector ahead of those of the vast majority of Americans. The declining real value of the minimum wage, weakening of union strength and membership, and decreasing regulation of the financial sector have created conditions in which those at the top have seen unprecedented wealth increases while the masses have been left behind. Contrary to trickle-down theory's stated goal of encouraging entrepreneurship, these trends undermine institutions and policies—such as strong labor unions—that may encourage hard work and provide a safety net for risk taking. In addition, Howell explains that the U.S. government has failed to take adequate measures on a number of fronts to combat this increasing inequality, thereby threatening economic growth. An increasingly technology-driven workplace, for example, has created more demand for high-skilled workers and less demand for low-skilled workers, and the government has failed to reform the educational system to adequately prepare low-skilled workers to participate in the changing labor market.

Howell identifies explicit linkages between inequality and economic inefficiency and hence reduced growth and stability. First, extreme inequality causes many individuals to be unable to access resources, and particularly credit, thereby reducing investments in physical and human capital that are so vital to economic growth. Second, extreme inequality can undermine social cohesion and breed crime, which necessitates increased public and private spending on security personnel and prisons. Third, income inequality promotes inefficient patterns of conspicuous consumption, where individuals feel pressured to consume more than is efficient as a sign of social status—such as overly large and expensive housing—which wastes resources that could be used for productive investments. Finally, job insecurity and a shredded safety net can reduce the incentives for risk-taking entrepreneurial behavior among those in the bottom 99 percent that can help produce long-run growth.

Furthermore, Howell finds a strong correlation showing that as the size of government shrinks, inequality increases. In a statistical analysis relating the Gini coefficient for disposable income—which is perhaps the best measure of a society's inequality—in 2000 to the Fraser Institute's measure of the size of government, nearly 60 percent of the variation in inequality was accounted for by size of government. The United States is an extreme example that fits this pattern well: It has extremely high inequality and a small government relative to the other nations in the study.

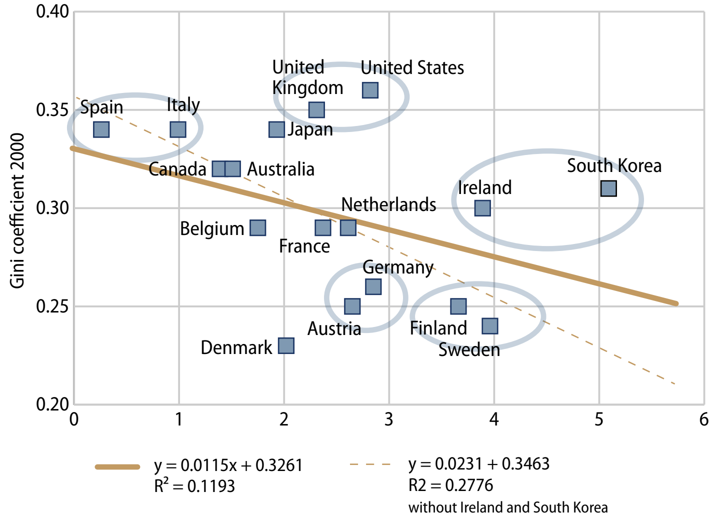
Notably, Howell jumps headfirst into the ongoing debate in academic literature about the empirical relationship between inequality and economic growth. He argues that recent research has "failed to produce a compelling case for a robust, positive, or negative relationship." Howell also points to a key methodological flaw in existing research that uses gross domestic product, or GDP, per capita to measure growth. Existing academic papers generally rely on changes in GDP per capita to measure economic growth, but that is problematic because demographic changes that have no direct bearing on growth—such as an increase in the share of children or the elderly—will affect GDP per capita; and GDP is often difficult to measure, particularly in cross-country comparisons. As Barro notes in his 2000 study, "One drawback of this kind of diverse sample is that it creates difficulties in measuring variables in a consistent and accurate way across countries and over time."[14]

To get around this, Howell develops a productivity-growth index—"measurable GDP per hour"—that removes difficult-to-measure sectors from the analysis; for example, finance, business services, and education, among others. While showing that there is no robust statistical relationship between the standard growth indicators—GDP per capita and GDP per hour—a clear inverse relationship emerges when setting the Gini index for disposable household income against this measurable productivity-growth indicator. Additionally, when omitting South Korea and Ireland from the sample, as they are arguably special cases in the post-1980 period, the negative relationship is even stronger: Among rich countries in the post-1980 period, higher-inequality countries tended to have slower growth (see figure 6).

Finally, Howell concludes that the United States has done poorly at sharing its productivity growth with its population, arguing that we should only care about economic growth in the first place if it is benefitting the majority of Americans. Yet he characterizes the past 30 years as a period in which the growth of our nation's income is almost entirely captured by the top 1 percent. The average annual growth in median income of American households has been much lower than in other rich countries, and this small increase has relied on increasing household hours of work. Looking to the future, Howell makes the case that increasing the minimum wage, making the National Labor Relations Board friendlier to unions, re-regulating the financial sector, raising taxes on the richest Americans, and increasing investments in public education such as universal preschool will increase prospects for greater shared growth in the future.

FIGURE 6

Household disposable income inequality (Gini coefficient 2000) and average annual real output growth per person (1994–2007) for 20 rich countries



Source: Author's calculations based on the EU-KLEMS Database. "Measureable productivity" is constructed by excluding industries associated with finance and government, in which the accuracy of output measurement, especially for cross-country comparisons, has been challenged (see text). In particular finance, insurance, real estate and business services (ISIC Rev. 3 codes J-K), as well as public administration, defense, compulsory social security, education, health, and social work (ISIC Rev. codes L-N) have been excluded from the output and employment measures. Productivity is defined as output per hour employed. All currencies are converted to U.S. dollars using 2011 purchasing power parity, or PPP.

'The Impact of Inequality on Growth'

Jared Bernstein's report[15] also serves to debunk the myth that inequality is necessary for overall economic growth. Bernstein develops several economic models that predict a negative relationship between inequality and economic growth and suggests several policy initiatives that fight the inequality that has held back our economy.

In the first model, income inequality creates inequities in the educational system, which causes underinvestment in low-income children inside and outside of the classroom. As argued by Nobel laureate economist Joseph Stiglitz, when children lack sufficient access to educational resources and afterschool activities such as art and music, they become less-effective inputs into our economy, thus depressing the rate of growth compared to a counterfactual scenario in which high-quality schooling is available to all children. This aligns with the work of other economists, such as James Heckman, who argue that educational investments in disadvantaged youth is not only fair but also create a more productive economy.[16]

Additionally, direct redistribution of income has the potential to simultaneously fight inequality and generate growth in two ways. First, because the marginal propensity to consume is lowest in the upper class, redistributing income away from the top and to the middle and the bottom should generate increased consumer spending and thus stimulate the economy, a particularly important mechanism in periods of recession and weak growth. Second, creating a more inclusive economic system will generate a more inclusive political system in which Americans will have a more equal voice in shaping policy. This could potentially push back on the recent government neglect of American income inequality and thus stimulate demand that would bolster our economy.

Finally, when wealth is concentrated in the hands of a select few, middle- and low-income families are forced to borrow to sustain their standards of living. This creates excessive middle-class debt; generating instability in financial markets, lower economic growth, and the potential for a market crash.

In light of these findings, Bernstein proposes several policies to help push back on the significant increase in income inequality. First, the federal government must help disadvantaged children overcome the barriers in our educational system through increased investment. Second, it must level the playing field for those workers who seek to form or join unions and increase the minimum wage to counter the lack of bargaining power of many in the workforce. Third, the government must take action to combat the influence of a wealthy few over our political system, which has contributed to policies that have fostered today's severe income inequality. Together, these policies will not only build a more equitable society, but they also may lead to more economic growth.

'The Impact of Redistributive Tax and Transfer Programs on Risk-Taking Behavior and Labor Mobility'

In her report,[17] Adriana Kugler demonstrates that the very policies designed to combat inequality also lead to a more efficient labor market with workers taking jobs that best utilize their skills, suggesting a link between fighting inequality and growing the economy. Her analysis points to an important and sustained role for U.S. government action to simultaneously accomplish those two goals.

A core component of a healthy labor market, which is necessary for a strong economy, is the ability for individuals to start their own businesses. Kugler finds that increasing food assistance to women and children through the Special Supplemental Nutrition Program for Women, Infants, and Children, more commonly referred to as WIC, is associated with a 2.5 percent increase in self-employment. Social programs can give aspiring entrepreneurs the safety net necessary to take risks for ventures that could be beneficial to our economic growth.

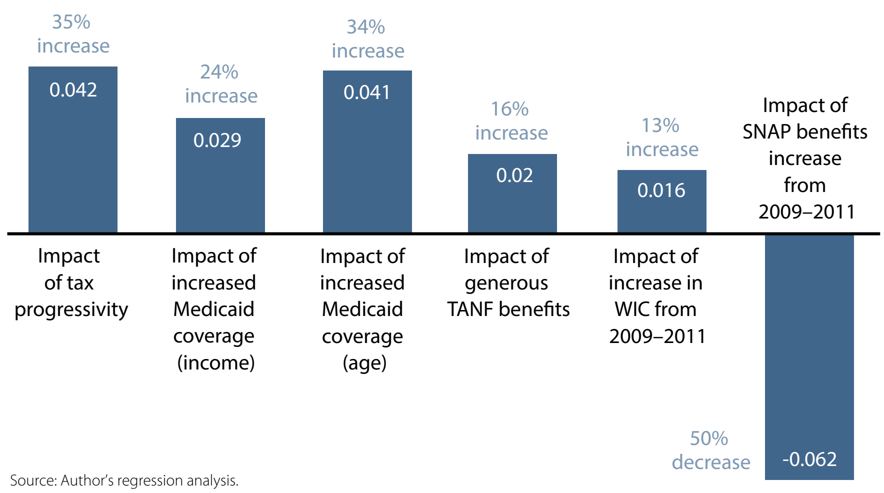
A well-functioning economy needs a healthy labor market that allows workers to find jobs that take advantage of their unique skills and experiences. But many workers may be reluctant to move to a new occupation, industry, or location because they are worried about ending up worse off. Over the course of Kugler's study, for example, only 12 percent of workers moved occupations and just 9 percent moved to different industries.

Kugler's findings make a powerful argument for the positive effect of redistributive policies on different types of worker mobility, allowing workers to be as productive as possible in the labor force and thus strengthening the economy. Kugler examines differences in the progressivity of state tax systems, defined as the difference in average tax rate for those at the top and bottom quartiles of the income distribution. She finds that an 11 percent increase in tax progressivity is associated with an increase in occupational mobility by 35 percent. An increase in the eligibility threshold for Medicaid by 122 percent is associated with an increase in occupational mobility by 24 percent. Likewise, increasing the generosity of programs such as the Temporary Assistance for Needy Families, or TANF, and the State Children's Health Insurance Program, or SCHIP, has similar positive effects on occupational mobility (see figure 7).

Increasing tax progressivity and Medicaid coverage generates higher industrial mobility, enabling workers to switch industries entirely if they feel that a switch would make them more productive. An 11 percent increase in tax progressivity is

FIGURE 7

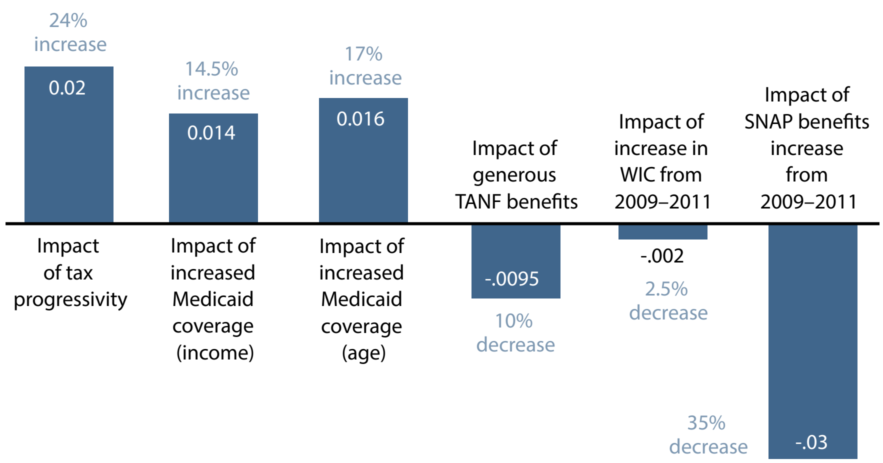
Impact of tax and transfer programs on occupational mobility



Source: Author's regression analysis.

FIGURE 8

Impact of tax and transfer programs on industrial mobility



Source: Author's regression analysis.

associated with a 24 percent increase in industrial mobility. As seen in figure 8, expanding Medicaid coverage also strongly impacts industrial mobility.

Geographical mobility is also important to a well-functioning labor market, enabling job seekers to move into areas with better job opportunities. In the Great Recession, for example, had job seekers in hard-hit areas sought employment in other locales more vigorously, that would have likely reduced the unemployment rate. Kugler finds that greater government support for children and a more progressive tax system are both associated with increased geographic mobility.

Kugler's findings tell a compelling story about the powerful role for government to create a healthier labor market. Increased mobility leads to a more productive workforce, which in turn leads to a more productive economy. Indeed, economists have repeatedly argued that labor mobility plays a critical role in creating widespread economic growth and shared economic prosperity.[18] Progressive taxation and social programs are key factors in creating a more prosperous economic future for our country.

Conclusion

Americans have seen income inequality rise over the past few decades, yet contrary to long-held trickle-down beliefs that rising inequality is not broadly benefiting society by bringing with it stronger economic growth. The research presented here demonstrates that inequality is not necessary for sustained economic growth and that inequality may actually dampen growth. This flies in the face of a core tenet of trickle-down theory, which erroneously vouches for the necessity of extreme inequality to generate growth.

As we get a clearer picture of the dangers of income inequality to our economic growth and prosperity, policymakers in Washington will be confronted with a clear choice: to attempt to grow the economy from the top down or from the middle out. Trickle-down economics is severely flawed; for decades, its associated economic policies have generated high levels of inequality, justifying that inequality with faulty logic, and most likely, dampened levels of economic growth. In contrast, middle-out policies, which combat inequality and strengthen the middle class through a progressive economic agenda, have the promise to bring about a new era of shared prosperity in our nation.

If policymakers want to do best by American working families and the American economy, they would do well to leave behind the failed trickle-down policies of the past and instead adopt the middle-out agenda that Americans so sorely need.

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Endnotes

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