Inequality, investment & trickle down

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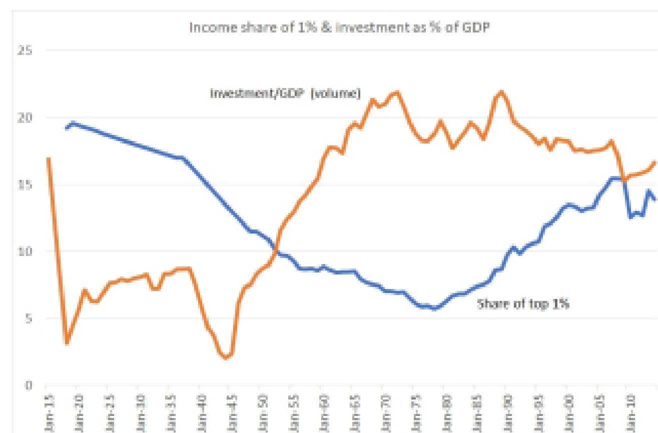
I've never been sure whether trickle-down economics was a genuine theory or a straw man which leftists attribute to the right. I was therefore surprised to see Tim Worstall write in defence of the idea that:

> *greater investment by the richer among us (this being the flip side of the obviously true greater marginal propensity to spend of the poor) creates a wealthier society over time.*

This claim, however, doesn't seem to me to be true. If it were, we'd expect to see higher inequality leading to higher investment. But this isn't the case. My chart shows that the share of investment in GDP rose in the 50s and 60s as inequality fell, and has fallen since the mid-80s as inequality rose.



This is the exact opposite of what we'd expect if Tim were right. It is, though, consistent with research at the IMF, which shows that inequality tends to reduce economic growth; for explanations of how this can happen, see the brilliant Sam Bowles (pdf.)

To see why might inequality reduce investment, first remember Keynes' point that a decision to abstain from consumption does not necessarily mean a decision to invest in productive assets. The rich's lower marginal propensity to consume might merely mean that they hoard their wealth.

This in itself is one reason for the pattern in my chart: insofar as greater equality means a higher propensity to consume, it tends to raise aggregate demand and hence strengthen the accelerator effect. We thus get more investment and wage-led growth. By the same token, inequality weakens the accelerator and so reduces investment and growth.

Alternatively, high inequality might cause the rich to fear a backlash in the form of higher taxes, political unrest or leftist governments which would deter them from investing: uncertainty alone depresses investment.

And then there's the fact that inequality causes the rich to try to entrench their privilege by investing in guard labour rather than more productive jobs, or by using the state to protect them from competition – for example by enforcing tough intellectual property laws, extracting subsidies for banks and corporate welfare, or imposing regulations which restrict creative destruction. In this way, investment and growth are choked off. In saying this, I'm not making a terribly radical point. In a new book Steven Teles and Brink Lindsey, who are no raving lefties, write:

> *The economic game has been rigged in favour of people at the top…the US economy has become less open to competition and more clogged by insider-protecting deals than it was just a few decades ago. Those deals make our economy less dynamic and innovative (The Captured Economy, p5)*

I'm not sure you can argue against all this on the grounds that inequality would raise investment and growth if all else were equal. The problem is that inequality affects pretty much everything – policies, institutions and the likelihood of financial crises. Very little is exogenous to inequality.

Instead, I suppose you could argue the following:

> *After WWII there was massive pent-up demand for investment, because the war had delayed the adoption of recent innovations. That led to rising capital spending. By the 1980s, however, that pent-up demand had disappeared, and a slower pace of innovation meant less investment. Quite by accident, these developments coincided with a decline and then rise in inequality.*

I suppose this might explain the pattern in my chart. But it doesn't explain the IMF's finding that inequality depresses growth. Nor does it dispose of the many mechanisms whereby it might do so.

I therefore side with Richard Murphy. Trickle down is indeed discredited. Defenders of inequality must come up with something better.