In Defense of Classical Liberalism
An Economic Analysis
For Catherine and Martha

- Matt
I am a liberal in the original sense – Milton Friedman
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Introduction

Classical liberalism is quite simply a philosophy committed to individual liberty, both economically and socially.

In the words of John C. Goodman, classical liberalism was “the political philosophy of Thomas Jefferson and the signers of the Declaration of Independence and it permeates the Declaration of Independence, the Constitution, the Federalist Papers and many other documents produced by the people who created the American system of government.”

It wasn’t even until the 19th century that the word “classical liberal” had to be coined, in order to differentiate itself from the new liberalism that we see today. Today, many of those identify as “libertarian” or “conservative” would be identified as “classical liberals” in the past. It’s for this reason that we opened with a quote from Milton Friedman, who was liberal “in the original sense.”

The purpose of this book is to deal strictly with contemporary economic issues from a classically liberal perspective. For a little under a year, Corey and I (Matt) have both run the popular online blog “Being Classically Liberal.” Corey would often come to me joking that he had enough material to throw together a book. Realizing that I was likely in the same situation, we decided to embark on the project which became this book a mere three months later.
The Virtue of the Market: In Defense of Economic Freedom

Corey Iacono

A Battle of Ideas

In his magnus opus, An Inquiry into the Nature and Causes of the Wealth of Nations, Adam Smith examined human nature and how it applies to economic interactions. In his work, Smith makes a very important observation: individuals pursue their own rational self-interests. This observation allowed Smith to show his readers that productive behavior is derived from an individual’s want to gain from his or her industry and that the economy as a whole runs on individuals pursuing their own interests in a way which benefits society as a whole. In book IV of the Wealth of Nations, Smith wrote:

Every individual [in the market economy]... neither intends to promote the public interest, nor knows how much he is promoting it... he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention.¹

Smith is of course referring to the invisible hand of the market, which is metaphor he created to describe the self-

regulating nature of the market economy. One example of the self-regulating nature of the market is how individuals and firms react to changes in prices, wages, and profits. If there are abnormally high profits in a given industry, likely a result of high demand, firms will enter the market of this specific industry and compete with each other until economic profit\(^2\) becomes zero, meaning that profits in a given industry are similar to the profits earned in other industries. In contrast, industries yielding low profits are unlikely to see an influx of firms seeking to compete. Indeed, in low-profit industries, firms are likely to close up shop and search for more profitable investments. In this way, the invisible hand of the market coordinates production in the most socially optimal way possible, guiding producers to meet the wants and needs of consumers.

In a society consisting solely of altruistic angels, Smith would be wrong. But as it was famously observed in Federalist #51, humans are not angelic beings. The reason why they work is to produce better lives for themselves and those they care for. Obviously human acts of altruism are a reality, but to rely on altruism as the sole motivation for productive activity is absurd. Unfortunately, Smith’s insight is often used by opponents of the market economy as proof that the market economy “runs on greed,” so to speak, or that proponents of free markets are proponents of greed. Nobel Prize winning economist Milton Friedman notably responded to this criticism by stating:

> Is there some society you know that doesn’t run on greed? You think Russia doesn’t run on greed? You think China doesn’t run on greed? What is greed? Of course, none of us are greedy, it’s only the other fellow who’s greedy. The world runs on individuals

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\(^2\) Economic profit is the difference between the revenue received from the sale of an output and the opportunity cost of the inputs used.
pursuing their separate interests. The great achievements of civilization have not come from government bureaus. Einstein didn’t construct his theory under order from a bureaucrat. Henry Ford didn’t revolutionize the automobile industry that way. In the only cases in which the masses have escaped from…grinding poverty… the only cases in recorded history, are where they have had capitalism and largely free trade. If you want to know where the masses are…worst off, it’s exactly in the kinds of societies that depart from that. So that the record of history is absolutely crystal clear, that there is no alternative way so far discovered of improving the lot of the ordinary people that can hold a candle to the productive activities that are unleashed by the free-enterprise system.³

Ultimately, proponents of the market economy don’t promote greed nor think that it is intrinsically desirable, they simply recognize, as Smith and Friedman did, that self-interested behavior is natural to humans, under any economic system, but that only free markets enable self-interested behavior to be used to benefit the whole of society.

Perhaps the most well-known critic of the free market economy was Karl Marx, the German philosopher and author of the *Communist Manifesto*. *Das Kapital*, however, is Karl Marx’s magnum opus in which he critically examines the Capitalist economic system as well as the proletariat’s (the working classes’) role in it. Perhaps the most widely known and recognized themes throughout *Das Kapital*, as well as Marx’s other contributions, is the concept of the exploitation of the proletariat at the hands of the

³ See the interview in which Friedman said this here: https://www.youtube.com/watch?v=RWsx1X8PV_A
capitalist, which in Marx’s view is inherent in the market economy.

But from where is Marx’s theory derived? In *Das Kapital*, Marx discusses the nature of a concept known as ‘surplus value.’ According to Marx’s theory, ‘surplus value’ is the value created by worker’s labor which surpasses the cost of their labor to the capitalist. Basically, the ‘surplus value’ of labor is the profit the capitalist makes when the products produced by the workers are sold. Thus, according to Marx, the nature of exploitation is that the capitalist takes the ‘surplus value’ (in the form of profits) which rightfully belongs to the worker. In his mind, exploitation is inherent in the capitalist economy since there will always be capitalists employing workers in order to produce goods and services from which they will profit.

Marx’s theory of exploitation rests on the labor theory of value, which posits that the value of a commodity is objective and depends on the number of labor hours which are needed to produce it. According to Marx:

> The value of one commodity is to the value of any other, as the labour-time necessary for the production of the one is to that necessary for the production of the other. As values, all commodities are only definite masses of congealed labour-time.\(^4\)

Thus, value is explicitly derived from the amount of labor, and how long it was utilized, that goes into the production process of a given product. Several famous classical economists such as Adam Smith and David Ricardo believed in this theory as well. Using the labor of theory of value, Marx was able to demonstrate that the income from the sale

of a good is divided into the wages paid to workers, the expenses of raw materials, and profits. The labor theory of value supports the belief that workers create all value and that capitalist claims on the surplus value from workers is exploitative in nature. In Marx’s view, “the rate of surplus-value is therefore an exact expression for the degree of exploitation of the labourer by the capitalist.” Thus, higher profits correspond with higher exploitation and vice versa. Ideally, in Marx's mind, profits would be non-existent and the surplus labor would be returned to the workers.

However, the labor theory of value does not adequately explain the actual nature of value and assumes that value is objective and measurable. If the value of goods was simply determined by how much labor went into it, two identical products would have different values just because one laborer took longer to produce his. By the late 19th century the economists of the Marginal Revolution, such as Leon Walras, William Jevons, and Austrian economist Carl Menger, recognized that value is not objective, it is subjective. Different people value different things for different reasons in different quantities. This powerful insight allowed Menger and other economists to develop the theory of marginal utility, which essentially argues that there is a gain (or loss) from the consumption (or loss) of an additional good or service and that these gains or losses are subjective and immeasurable.

These revelations allowed economists to recognize that voluntary trade is mutually beneficial since the parties involved subjectively value the product or service that they are receiving more than whatever they are giving up in exchange for it. In the relationship between workers and

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5 Ibid. (III.IX.13)
capitalists, the workers value their wages more than their time, and they are willing to trade their labor for the wages offered by the capitalist (which are mutually agreed upon). The capitalist is willing to pay the worker money now for labor to produce products which he/she thinks will be profitable when sold in the future.

In contrast to Marx’s theories, the market economy is based on mutually beneficial voluntary exchanges, if this were not the case, trade would not commence. Furthermore, employers cannot simply offer potential employees close to nothing for their labor since they have to compete with other employers for it. The more productive employees are, and thus, the more revenue they produce for their employer, the higher wages the employer will be willing to pay to ensure the employee is not hired by competitors. Because of this, economists widely believe that worker compensation is based off worker productivity, not the whims of their employer. The following charts demonstrate the relationship between worker productivity and worker compensation per hour over several decades are shown below for Canada\textsuperscript{7}, the United Kingdom\textsuperscript{8}, and Untied States\textsuperscript{9}.

\textsuperscript{7} Gordon, Stephen (2013). Intro to productivity (that thing Canadians are apparently so bad at). MaClean’s.com <http://www.macleans.ca/economy/business/intro-to-productivity-that-thing-canadians-are-apparently-so-bad-at/>
\textsuperscript{8} Paulo Pessoa, João and Van Reenen, John (2013). Decoupling of Wage Growth and Productivity Growth?
\textsuperscript{9} Ibid.
If Marx were right that market economies are inherently exploitative, they sure are doing an awful job of it. According to the Fraser Institute, both the average citizen and the poor who reside in countries with market economies are much better off than those which reside in countries with a non-market or restricted market economy. They measured this by creating a widely used index of Economic Freedom, which scores countries based on the following five criteria (which can be further broken down into 42 distinct and measurable variables):

1. The Size of Government
2. Legal system and Property Rights
3. Sound Money
4. Freedom to Trade Internationally
5. Regulation

As one could guess, economic freedom consists of small government, minimal and effective regulation, freedom to trade internationally, a legal system which protects private property rights, etc. This index, known as the Economic

10 To read about the index visit the following website: http://www.freetheworld.com/2013/EFW2013-complete.pdf
Freedom of the World Index, has allowed researchers to compare how economic freedom affects a country’s economic and social outcomes. Using the Fraser Institute’s most recent data, for the year 2011, researchers have found that:

[Among countries] in the top quartile [of economic freedom], the average income of the poorest 10% was $10,556, compared to $932 in the bottom [economic freedom] quartile in 2011 US (PPP) dollars. Interestingly, the average income of the poorest 10% in the most economically free nations is more than twice the overall average income in the least [economically] free nations. [These numbers are adjusted for cost of living differences between nations.]

But why is this the case? In order to understand how economic freedom, or Capitalism, makes everyone rich, we need to examine its relationship with economic growth.

**Economic Freedom and Economic Growth**

Economists such as Adam Smith, David Ricardo, F.A Hayek, and Milton Friedman have all theoretically explained why free markets and free trade result in faster economic growth, but why is economic growth important, and what does the empirical evidence say on the matter? First, we must examine how the variables in question are measured. The economy is typically measured as Gross Domestic Product (GDP), which is the total market value of all goods and services produced in a given year. Furthermore, GDP per capita (per person) is often used as a measurement of a country’s material standard of living, since it is a measure of a country’s average income per person. The World Bank itself has stated, “GDP per capita is the best single measure at hand to proxy a country’s living standards.”
In fact, a 2013 study published by the World Bank, which examined 118 countries over four decades, found that 75% of the income gains accruing to the bottom 40% of income earners were a result of economic growth (increased production), which suggests that not just the wealthy benefit from it. These findings also suggest that economic growth should be at the forefront of any anti-poverty program. Indeed, research published in the National Bureau of Economic Research has found that economic growth has led to massive reductions in global poverty over the last few decades. According to the authors:

Using the official $1/day line, we estimate that world poverty rates have fallen by 80% from 0.268 in 1970 to 0.054 in 2006. The corresponding total number of poor has fallen from 403 million in 1970 to 152 million in 2006…[also] various measures of global inequality have declined substantially and measures of global welfare increased by somewhere between 128% and 145%... we observe that poverty rates and GDP per capita behave as “mirror images” of one another: whenever GDP grows, poverty tends to decline and whenever poverty declines, GDP tends to grow.
Furthermore, GDP per capita is highly correlated with numerous measures of the general well-being of a country. Everything from human development, happiness, life expectancy, educational and health outcomes, intelligence, employment, etc are all positively related to GDP per capita.¹¹

Thus, economic growth is extremely important for raising incomes and improving a country’s standard of living. So how does economic freedom influence it? In order to examine how economic freedom affects economic growth, one must have a means to measure it. As previously mentioned, the Fraser Institute has provided such a means. But they aren’t the only ones to do so, the Heritage Foundation has as well. However, since the Fraser Institute’s

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index is the most widely used, most of the research cited in this book relies on that index.

Using data from the Fraser Institute’s Economic Freedom of the World Index, economists at the World Bank’s International Trade Department reviewed the economic performance of over 100 countries over three decades and found that the more economically free a country was, the faster its economy grew. For instance, according to the authors, a one unit change in the initial level of economic freedom between two countries (on a scale of 1 to 10) is associated with an almost 1 percentage point differential in their average long-run economic growth rates (after accounting for other factors which affect economic growth).

To demonstrate how much of a difference that a 1 percentage point gap in long run growth matters, consider two economies, one growing at 3% a year, and another at 4% a year. The economy growing at 3% annually will double in approximately 24 years, but the economy growing at 4% a year will double in 18 years (25% faster).

These findings demonstrate that economic freedom has a significant positive impact on economic growth. Secondly, the authors find that political freedom (such as freedom of speech) is positively related to economic growth as well, although to a lesser degree. The authors conclude the paper by stating, “The empirical findings in this paper
suggest that fundamental freedoms are paramount to explaining long term economic growth.”

**Economic Freedom and Economic Growth, 1990-2010**

![Graph showing economic growth by economic freedom quartile](image)

Source: Fraser Institute

This isn’t just one study coming to this conclusion, the enormous amount of research on this subject continually finds that economic freedom promotes stronger economic growth. According to a review of over 40 studies on the matter, conducted by economists Chris Doucouliagos and Mehmet Ali Ulubasoglu:

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[Our] meta-analysis shows clearly that there is a positive and statistically significant association between economic freedom and economic growth. Importantly, this association is very robust. That is, regardless of the sample of countries, the measure of economic freedom and the level of aggregation, there is a solid finding of a direct positive association between economic freedom and economic growth. This association is both statistically significant and of economic importance. In addition, economic freedom has an indirect positive effect on economic growth through its positive impact on physical capital formation. It was shown also that economic freedom has a significantly greater effect on economic growth than does political freedom.\(^{13}\)

Moreover, economic freedom explains anywhere from 54 to 74 percent of the difference in cross-country variations in national income, meaning that differences in economic freedom between countries largely explains differences in how wealthy they are.\(^{14}\) However, correlation doesn’t prove causation, leading numerous studies to attempt to determine the direction of causality in the relationship. The findings of these studies unambiguously show that economic freedom causes economic growth, as shown below.


Studies on Causality in the Freedom and Growth Relationship:

<table>
<thead>
<tr>
<th>Study:</th>
<th>Results:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gwartney, Holcome and Lawson (2006)&lt;sup&gt;15&lt;/sup&gt;</td>
<td>Increase in economic freedom lead to increases in economic growth. Prior growth rates exert a negative impact on the future change of economic freedom.</td>
</tr>
<tr>
<td>Dawson (2003)&lt;sup&gt;16&lt;/sup&gt;</td>
<td>The level of economic freedom causes growth, but not the other way round.</td>
</tr>
<tr>
<td>Vega-Gordillo and Alvarez-Arce (2003)&lt;sup&gt;17&lt;/sup&gt;</td>
<td>The level of economic freedom causes growth, but not the other way round.</td>
</tr>
<tr>
<td>Aixalá and Fabro (2008)&lt;sup&gt;18&lt;/sup&gt;</td>
<td>Bilateral causality between the level of the economic freedom, the change in economic freedom, and economic growth, meaning freedom and growth cause each other.</td>
</tr>
<tr>
<td>Faria and Montesinos (2009)&lt;sup&gt;19&lt;/sup&gt;</td>
<td>Economic freedom causes economic growth.</td>
</tr>
<tr>
<td>Justesen (2008)&lt;sup&gt;20&lt;/sup&gt;</td>
<td>Economic freedom causes growth. There is only weak evidence that growth causes freedom.</td>
</tr>
</tbody>
</table>

Moreover, a comprehensive study the Illinois Wesleyan University economics department examined how economic freedom affected several different measures of a country’s standard of living, which include human development (measured using the human development index), life expectancy, educational attainment, and real GDP per capita (which we have already examined). According to the authors, “The empirical results support the hypothesis that increased economic freedom leads to an improvement in the quality of life.”21 Indeed, all measures of the quality of life used in the study were positively correlated with economic freedom. Empirical research also finds that economic freedom leads to a host of other desirable outcomes.

**Economic Freedom and the Business Cycle**

Economist John Dawson found that, in a sample of 85 countries, there was a significant negative relationship between economic freedom and business cycle volatility, which refers to fluctuations in economic activity, even after controlling for other relevant variables and checking for reverse causality. According to Dawson, “freedom appears to allow economies to better adjust to those shocks that drive business cycles”.22

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These findings are in accordance with earlier research on the matter. On the other hand, a paper published by the University of Arkansas found that after a country reaches high levels of economic freedom, “the improvement in volatility diminishes as freedom increases.”

**Economic Freedom and Employment**

Economist Horst Feldmann of the University of Bath used data from 87 countries over the time period 1980-2003 and found that economic freedom substantially reduces unemployment, especially among women and young people. For the United States specifically, economists Lauren Heller and Frank Stephenson found that among the states, “economic freedom is associated with lower unemployment and with higher labor force participation and employment-population ratios.”

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Economic Freedom and the Environment

- Research conducted by economists Joel Wood and Ian Herzog finds that economic freedom is associated with less air pollution in a data set of over 100 countries (after controlling for other relevant factors). In regards to how economic freedom affected carbon dioxide emissions, they could not find evidence of a relationship.

- Using the Heritage Foundation’s economic freedom index, James Roberts and Ryan Olson found that nations with higher economic freedom scored higher on Yale University’s Environmental Performance Index (EPI). They also found that, more economic freedom was associated with improved health and health care, lower infant-mortality rates, better education, cleaner water, and improved sanitation.

- Research from economist Michael Stroup examined how economic freedom was related to air and water pollution in developed countries. After controlling for variables such as per capita GDP, urbanization, population, etc, he found that

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nations with more economic freedom experienced less pollution and higher environmental quality.\textsuperscript{29}

Thus, it seems fair to say that there is overwhelmingly evidence which supports the belief that economic freedom causes economic growth, and that fostering greater economic freedom will lead to higher incomes, less poverty, and a higher standard of living for everyone. While these findings have important implications for developed countries, they have most importance for developing countries who have a long way to go in terms of raising their citizens’ standard of living. Indeed, research finds that developing countries can increase the usefulness of their national resources by approximately 45\% simply by converting to market-based economies.\textsuperscript{30}

Such large economic gains are impossible to ignore. In the following chapters, we will examine the benefits of specific components of economic freedom, such as limited government, free trade, and effective regulation.

\textsuperscript{29} Michael Stroup, “Separating the Influence of Economic Freedom and Democracy on Air Pollution Emissions among OECD Countries,” 2007 working paper, \textless http://www.cob.sfasu.edu/mstroup/Pollution_10_15.pdf.\textgreater

The Blessing of Free Trade: Trade, Growth, and Poverty

Countries can increase their rate of economic growth quite significantly by being open to international trade. Indeed, since the time of Adam Smith, economists steadfastly supported free trade, which is the unrestricted purchase and sale of goods and services between countries without the imposition of constraints such as tariffs, duties and quotas. In fact, 93% of economists believe that tariffs and quotas (which are barriers to trade) reduce economic welfare and 90% believe that the United States should not restrict employers from outsourcing work to foreign countries. After all, as Smith noted in the Wealth of Nations:

It is the maxim of every prudent master of a family, never to attempt to make at home what it will cost him more to make than to buy...If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage.

If foreigners can make products better and more cheaply than domestic producers, than why not let citizens buy foreign products? If consumers were not made better off as a result of these foreign products, than they wouldn’t buy them. If, for example, the South Koreans make the best cars and charge the lowest prices, American consumers benefit from trading with them. If foreigners fail to deliver quality products at reasonable prices there is no incentive for domestic consumers to purchase their products. Ultimately,

any restriction of international trade necessarily reduces the economic welfare of domestic consumers by denying them the option to purchase products which are less costly than the ones produced domestically.

We can also expect trade between nations to result in faster economic growth according to classical economist David Ricardo’s theory of *comparative advantage*. An in depth explanation of Ricardo’s theory is outside the scope of this book, but the reader should know that it explains that different countries (or individuals) have different opportunity costs and that these differing opportunity costs lead to gains from trade for both the parties involved in it.

For example, a lawyer could either book his own meetings and make his own schedule or hire a secretary to do it. Even if the lawyer is better than his secretary at such tasks, the time he spends doing them is time that could have been spent doing his primary job, which is being a lawyer. This lost time is essentially lost income, which is the opportunity cost. Thus, instead of spending time doing secretarial tasks, the lawyer hires a secretary at an expense which is less than the opportunity cost of doing the tasks himself. In this case, both the secretary and the lawyer gain from trade by being able to focus on tasks in which they have specialized, and thus tasks in which they are more productive.

In the context of international trade, foreign countries produce goods and services that the United States would rather not commit resources to due to large opportunity costs which reduce domestic productivity. The theory of comparative advantage is at the core of economist’s support for free trade and economist Paul Krugman once quipped that, “If there were an Economist's Creed, it would surely contain the affirmations 'I understand the Principle of
Comparative Advantage' and 'I advocate Free Trade.'”\textsuperscript{32} Indeed, trade has an important and verifiable role in making a country’s citizens wealthier. For example, of the 14 main multi-country econometric studies undertaken since 2000, all 14 have concluded that trade plays an independent and positive role in raising incomes.\textsuperscript{33}

**Trade Openness and Economic Growth**

Nearly all the empirical evidence on the relationship between trade openness and economic growth finds that openness has a significant positive effect on growth. Research from Romain Wacziarg and Karen Horn Welch is specifically worth mentioning since it demonstrates how much countries can expect to gain from becoming more open to trade through the reduction of tariffs, quotas, etc (also known as trade liberalization). In their paper, the two economists examined 141 episodes of trade liberalization, and after controlling for other well-known determinants of growth, found that the impact of liberalization on economic growth was both positive and substantial. According to a summary of their research, “Per capita growth of countries liberalization was some 1.5 percentage points higher than before liberalization, and investment rates were 1.5- 2.0 percentage points higher.”\textsuperscript{34}

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Subsequent research from A. Estevadeordal and A. M. Taylor took the analysis further by comparing growth rates before and after 1990 when a wave of trade liberalizations occurred. The economists divided countries into an experimental group, the countries which liberalized trade regimes, and a control group, those that did not. According to a summary of their research, “[the authors] find strong evidence that liberalization of tariffs on imported capital and intermediate goods raised growth rates by about one percentage point annually in the liberalizing countries.”

Most likely as a result of economic growth, research has found that trade has a significant positive impact on worker’s

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35 Ibid.
37 “Trade and Employment in a Fast Changing World.”
wages. In contrast, tariffs, which are taxes on imports and exports, have been found to have significant negative effects on wages.

All this being said, it is worth noting that trade openness itself does not guarantee prosperity. According to the Organization for Economic Co-Operation and Development:

Trade can play a powerful role in contributing to rising incomes and creating jobs. To be effective trade reforms have to be embedded in supportive policies. Countries where trade openness has failed to provide a growth stimulus commonly have unstable macroeconomic policies, inadequate property rights, a dearth of public...

Source: OECD

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39 Ibid.

40 “Trade and Employment in a Fast-Changing World.”
investment in overcoming supply-side constraints, or other socio-political constraints.\textsuperscript{41}

**Trade Openness and Poverty**

Some anti-globalizers and opponents of free trade fear that openness to trade will lead to poor countries being driven further into poverty while exacerbating income inequality and leading to worse working conditions. However, the aforementioned research suggests the opposite is true, that openness to trade increases economic growth quite tremendously, leading to rising incomes, and less poverty. Indeed, research from Swedish economist Andreas Bergh finds a robust negative correlation between low barriers to trade and absolute poverty, which suggests that trade openness leads to poverty reduction.\textsuperscript{42} A survey of over 100 studies on the subject of trade openness, growth, and poverty published by the International Monetary Fund came to the following conclusions:\textsuperscript{43}

1. Poverty reduction is mainly driven by growth in per capita income.
2. Trade openness is an important determinant of economic growth.
3. The economic growth associated with trade liberalization is as pro-poor as economic growth in general (meaning that it isn’t economic growth which simply benefits a privileged few).

\textsuperscript{41} Ibid.
Another review of the empirical literature on the matter states:

The large body of empirical work on the topic strongly supports the theoretical presumption that trade liberalization reduces poverty on average and in the long run. Moreover, there is no evidence that it leads to an increase in poverty.\(^{44}\)

The economic reforms undertaken by China in the late 20\(^{th}\) century is a prime example of how trade liberalization and privatization can bring millions out of poverty. China currently has a population of over 1.3 billion and it managed to bring down the share of its people living in poverty from 53% at the onset of economic reforms in 1981 to 8% twenty years later.\(^{45}\) This suggests that over 400 million people have risen out of abject poverty in China alone since it began economic liberalization. In fact, research from Oxford University’s Economics Department finds that China’s economic growth, which drove its poverty reduction, was driven by trade liberalization, rapid privatization, and sectorial changes.\(^{46}\) As a result of these reforms, China’s GDP per capita grew 4.1 percentage points faster than it otherwise would have, lifting literally hundreds of millions out of poverty.\(^{47}\)

In regards to privatization, a survey of the empirical literature published in the Journal of Economic Literature


\(^{45}\) Ibid.


\(^{47}\) Ibid.
found that, “In most settings, privatization "works" in that the firms become more efficient, more profitable, financially healthier, and reward investors.”\(^{48}\) Of course, it should be noted that privatization is not always desirable.\(^ {49}\)

Without reform, it unlikely that China would have seen such rapid poverty reduction. Research conducted by economist David Dollar of the World Bank has shown that the only developing countries which have experienced significant reductions in poverty in the last few decades were those which integrated into the world economy by becoming more open to international trade.\(^ {50}\)

In regards to inequality, an exhaustive review of the evidence on income inequality and trade conducted by the Organization for Co-operation and Development found that “there is virtually no evidence that trade has played a major and/or systematic role across countries in increasing household income inequality in either high income or in developing countries.”\(^ {51}\) On top of that, the same study finds that trade does not result in a “race to the bottom,” contrary to the beliefs of the opponents of free trade. According to the authors:

> Trade does not systematically undermine working conditions in developing countries whether measured by job


\(^{49}\) To give just one example of when privatization may not be ideal, consider the privatization of prisons, which aligns incentives in favor of growing the prison population.


\(^{51}\) “Trade and Employment in a Fast-Changing World.”
quality, safety, child or female labor – and indeed there is some evidence that trade contributes to better working conditions, either directly through FDI (foreign direct investment) and labor standards, or indirectly through growth effects.52

Thus, it seems as though many of the fears of adverse consequences of free trade are unfounded. Indeed, after reviewing the research on the relationship between trade and the wellbeing of the poor, economists Jagdish Bhagwati and T.N.Srinivasan concluded with the following statement:

It is hard… to concur with the many critics of freer trade (and direct foreign investment) that see the heavy hand of globalization casting its evil spell on the poor of the poor countries. The empirical truth seems to be exactly the opposite.53

**Trade and Employment**

Like immigration, trade is commonly thought to have detrimental effects on domestic employment. Many Americans have seen that foreigners now produce things Americans used to and conclude that if this were not the case, more Americans would be employed. However, people buy foreign goods oftentimes because they are less expensive than those produced domestically. The money saved is often spent elsewhere, creating jobs in other domestic industries. Furthermore, the money spent buying foreign goods eventually comes back to the U.S via foreign investment, consumption of our exports, etc. In short, there are a number of theoretical reasons why importing goods

52 Ibid.

from foreigners won’t harm domestic employment, but ultimately, what the empirical evidence has to say on the matter is most important.

On this note, researchers from Syracuse and the University of California examined several developed and developing countries in order to see how trade liberalization affected domestic unemployment. According to their findings, “we find an unemployment-increasing short-run impact of trade liberalization, followed by an unemployment-reducing effect leading to the new steady state.” Ultimately, according to the study, the long run benefits of trade liberalization outweighed the short run costs such that

Graph source: OECD\textsuperscript{54}

\textsuperscript{54} “Trade and Employment in a Fast-Changing World.”


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unemployment drops 3.5% less than five years after liberalization. Other researchers have come to similar conclusions, according to a review of dozens of studies which examine the relationship between trade and employment:

> These results generally suggest that imports may cause job displacement in the short run, due to adjustment costs. By contrast, exporting is generally associated with lower rates of job losses and higher rates of job creation. While far fewer studies have been able to consider differences between the long and short run, those that have done so generally find that, in the long run, there appears to be a positive relationship between imports and employment.⁵⁶

It should be noted that the cost of “saving” domestic jobs is enormous. According to the Library of Economics and Liberty:

> …one study in the early 1990s estimated that U.S. consumers paid $1,285,000 annually for each job in the luggage industry that was preserved by barriers to imports, a sum that greatly exceeded the average earnings of a luggage worker. That same study estimated that restricting foreign imports cost $199,000 annually for each textile worker’s job that was saved, $1,044,000 for each softwood lumber job saved, and $1,376,000 for every job saved in the benzenoid chemical industry. Yes, $1,376,000 a year! While Americans may be willing to pay a price

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to save jobs, spending such enormous sums is plainly irrational.\textsuperscript{57}

In the United States, the Federal Reserve Bank of St. Louis has estimated that protectionism has had a net economic welfare cost of 1.45% of GDP in 1996, which is a cost of over $150 billion today.\textsuperscript{58}

**What about Infant Industries?**

The infant industry argument posits that domestic industries which are small need to be protected from foreign competition until a time when they can compete with them. How proponents define what constitutes an “infant” industry and its point of maturity remains a mystery. Its proponents argue that the benefits of protecting these ‘infant industries’ will far outweigh the costs of doing so. For example, according to economist Ha Choon Chang, who is frequently cited by opponents of free trade:

There is a respectable historical case for tariff protection for industries that are not yet profitable. . . . . By contrast, free trade works well only in the fantasy theoretical world of perfect competition.

Chang’s comments are quite puzzling since proponents of free trade don’t assume there is perfect competition. Even giants for the cause like Milton Friedman acknowledged that perfect competition is no more than a “theoretical

\textsuperscript{57} Blinder, Alan. Free Trade. The Library of Economics and Liberty. \textless http://www.econlib.org/library/Enc/FreeTrade.html\textgreater

\textsuperscript{58} Wall, Howard. Using the Gravity Model to Estimate the Costs of Protection. Federal Reserve Bank of St. Louis. \textless http://research.stlouisfed.org/publications/review/99/01/9901hw.pdf\textgreater
concept."  Proponents of free trade simply recognize that if one country can produce a product at a lower opportunity cost than another, trade between said countries is mutually beneficial and the empirical evidence consistently verifies the conclusion that countries more open to trade have faster growing economies. Moreover, there are a few theoretical and empirical reasons to be skeptical of the infant industry argument. As Austrian economist Robert Murphy has pointed out:

Plenty of new firms, especially sole proprietorships, don't make money in their first few years of operation. But so long as the present value of the firm's expected future cash flows is positive, the firm's owners should be able to borrow money to finance the first few years as they develop experience, name brand trust, etc.

If a firm or group of firms can't achieve funding from private investors to go ahead with their projects because the present values of their ventures are negative, then that is the market's way of saying that their schemes would squander valuable resources in the short run without sufficiently compensating gains in the long run. The advocate of a tariff to promote an infant industry is thus saying that he or she knows better how to determine intertemporal tradeoffs than the average person in his decisions to borrow or lend money at different rates of interest.


In short, if it is likely that a particular firm will be profitable in the long run than it doesn’t need to be protected because private investors will be willing to supply it with loans sufficient to cover the firms short run costs (with the expectation that the investors will make a profit off the loan). But let’s not let this argument rely solely on theory since several economists have taken the time to study the effects of the protection of infant industries on economic welfare.

In the late 19th century the United States placed tariffs on foreign steel in order to promote domestic infant industries. According to research by Douglas Irwin, welfare calculations show that such protections did not pass a cost-benefit test. The protection of infant semiconductor industries in Japan were also shown to have caused a net loss in economic welfare by economists Paul Krugman and Richard Baldwin. In Brazil the protection of the microcomputer industry lead to the widening of the technological gap between themselves and the rest of the world.

In a review of evidence on the matter conducted by the U.S Agency for International Development, it was found that infant industries often imposed unintended and costly consequences since such industries exploited their political preference for personal gains. Furthermore, it was noted that protected infant industries almost never mature to a point where they shed their protection. According to the authors:

Instances of protected firms doggedly improving efficiency while being protected and then contentedly accepting liberalization are extremely rare... the evidence presented here contradicts traditional infant-industry arguments... infant-industry policies often inhibit productivity, give rise to unintended consequences in the political economy, and sacrifice comparative advantage.  

As Jagdish Bagwhati of Columbia University has said, “There are so many infants which move into senility with diapers on,” drawing humor to the fact that so-called ‘infant industries’ never seem to grow up.  

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35
## Annex. Studies on Trade Openness and Growth

<table>
<thead>
<tr>
<th>Study</th>
<th>Method:</th>
<th>Effect of trade openness on economic growth:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Berg and Krueger (2003)</td>
<td>Literature review of more than 100 studies</td>
<td>Positive effect of trade openness on growth Also, trade reduces poverty by increasing growth</td>
</tr>
<tr>
<td>Hallaert (2006)</td>
<td>Literature review of approximately 50 studies</td>
<td>Positive effect of trade openness on growth</td>
</tr>
<tr>
<td>Cline (2004)</td>
<td>Literature review of more than 100 studies</td>
<td>Positive effect of trade openness on growth Trade reduces poverty by increasing growth</td>
</tr>
<tr>
<td>Baldwin (2003)</td>
<td>Literature review of more than 30 studies</td>
<td>Positive effect of trade openness on growth</td>
</tr>
<tr>
<td>Winters (2004)</td>
<td>Literature review of approximately 50 studies</td>
<td>Positive effect of trade openness on growth</td>
</tr>
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66 “Trade, Growth, and Poverty: A Selective Survey.”

The Costs and Benefits of Government Regulation

Amendments made to the Clean Air Act, which is a federal law in the United States meant to control air pollution, have been shown to have large economic benefits which make the cost of compliance with the law seem meager. Indeed, according to the Environmental Protection Agency, the annual cost of the regulations associated with the Clean Air Act will be $65 billion annually by the year 2020. However, the economic benefits of the regulations, which result from significant reductions in air pollution-

<table>
<thead>
<tr>
<th>Author(s)</th>
<th>Literature Review</th>
<th>Result</th>
</tr>
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<tbody>
<tr>
<td>Rodriguez and Rodrik (2000)</td>
<td>Literature review of over 100 studies</td>
<td>No effect</td>
</tr>
<tr>
<td>Srinivasan and Bhagwati (2001)</td>
<td>Literature review of more than 50 studies</td>
<td>Positive effect of trade openness on growth</td>
</tr>
</tbody>
</table>

related premature death and illness, are estimated to be worth over $2 trillion by 2020.\textsuperscript{74} Clearly, this is a case where regulation was a clear net gain for the American people.

However, not all regulations or regulatory agencies pass the cost benefit test, and most probably don’t. Consider the Occupational Safety and Health Administration (OSHA), whose mission is to “assure safe and healthful working conditions for working men and women by setting and enforcing standards and by providing training, outreach, education and assistance.”\textsuperscript{75} Most people would probably think the U.S needs a regulatory agency like OSHA, however, it’s effectiveness is questionable. According to historian Thomas E. Woods:

An evaluation of OSHA’s performance a quarter century after its creation discovered, after a survey of the existing literature, that its effects on workplace safety had been negligible, and that the costs it imposed on the private sector far outweighed the alleged benefits. “The most optimistic figures,” wrote Professors Thomas Kniesner and John Leeth, “show OSHA currently creating three times more costs than it generates in benefits.” Increasing its funding seems unlikely to make much difference; Quebec spends over four times as much per worker and has had no more success than OSHA.\textsuperscript{76}

Furthermore, although specific regulations (and a certain degree of regulation) are certainly necessary, it is also true that there is a point where the costs of the regulatory burden as a whole exceed its benefits. In fact, according to research conducted by economists John Dawson and John Seater, the accumulation of federal regulations over time has

\begin{itemize}
  \item \textsuperscript{74} Ibid.
  \item \textsuperscript{75} OSHA About page. <https://www.osha.gov/about.html>
  \item \textsuperscript{76} Woods, Thomas. Rollback. Chp. 6 pg. 28
\end{itemize}
become a significant burden on the U.S economy. In their own words:

Regulation’s overall effect on output’s growth rate is negative and substantial. Federal regulations added over the past fifty years have reduced real output growth by about two percentage points on average over the period 1949-2005. That reduction in the growth rate has led to an accumulated reduction in GDP of about $38.8 trillion as of the end of 2011. That is, GDP at the end of 2011 would have been $53.9 trillion instead of $15.1 trillion if regulation had remained at its 1949 level.\textsuperscript{77}

It should be noted that this study took into account the economic benefits of regulation but not the social benefits of it. In truth, these results are staggering and suggest that federal regulation have made the average American 72% poorer than they otherwise would have been. Based on these findings, Ronald Bailey of Reason Magazine has noted:

As a result [of the increase in federal regulations], the average American household receives about $277,000 less annually than it would have gotten in the absence of six decades of accumulated regulations—a median household income of $330,000 instead of the $53,000 we get now.\textsuperscript{78}


\textsuperscript{78} Bailey, Ronald. 2013. Federal Regulations have made you 75% poorer. Reason Magazine. \texttt{<http://reason.com/archives/2013/06/21/federal-regulations-have-made-you-75-per>
In regards to the effects of state and local regulations on economic growth, a review of the empirical findings of 160 studies published since 1990 found that 68% of the studies found the regulatory burden to have a significant negative effect on economic growth. Only 3% found that the regulatory burden had a significant positive effect on growth.

Regulations which inhibit competition are found to be especially harmful, a simple correlation between the level of anti-competitive regulation and the size of the economy is shown above for a number of countries. However, simple correlations are only suggestive evidence, numerous studies

80 Ibid.
have accounted for other factors which affect growth in order to isolate and observe the impact of regulation on growth. According to a review of the evidence provided by many of such studies from economists at the OECD:

- Countries and industries where direct and indirect regulatory burdens are lighter have generally experienced the highest GDP per capita and productivity growth rates.
- Evidence at the firm level suggests that, where regulatory burdens are lighter, the reallocation of resources towards the highest-productivity firms is stronger. Moreover, firm-level productivity growth is also curbed by anticompetitive regulations.
- The implications of inappropriate regulations for productivity performance are estimated to be quantitatively important. Therefore, reforming such regulations can provide a significant boost to potential growth in OECD economies.  

Thus, while a certain degree of regulation is necessary, it is also important to weigh the costs and benefits of such regulations. Luckily, regulatory agencies like the Environmental Protection Agency and Food and Drug Administration already do this. Moreover, this body of research suggests that deregulation will most likely lead to economic welfare gains for the average citizen, but once again, potential gains should be weighed against potential losses in social welfare before any action is pursued.

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82 Ibid.
In introductory economics, we learn that the prices of goods and services are determined by the supply and demand for those goods or services. Wages are another type of price – not the kind of price you pay for an item – but the price employers pay for labor. Price floors are a minimum price that someone can charge for an item (as opposed to a price ceiling, which is a maximum, such as rent control). Minimum wages act as a price floor in the labor market. Charted below is a supply and demand curve for a low skilled worker with a minimum wage factored in.
The $6 figure is the hypothetical wage that would arise for a particular low skilled worker in the absence of intervention, due to the forces of the supply and demand for labor. At the price floor of $7.25, the supply of workers desiring to be employed shifts up to point B, while the demand that employers have for workers retracts to point A. Obviously, this creates an inefficiency in the economy, as the supply of labor exceeds demand unemployment arises (visualized by the shaded region).

The economic literature supports this model of the labor market. When UC Irvine professor David Neumark surveyed studies on the topic, he found that roughly 85% of studies support a negative association between the minimum wage and employment.\textsuperscript{83} The consensus among economists supports this view as well. When the American Economic Association (AEA) surveyed its members, it found in 1976 that 90% of its members agreed that the minimum wage led to youth and low skilled unemployment, while in 1990 80% agreed with the claim.\textsuperscript{84} A 2006 survey of the AEA found that nearly half of respondents supported eliminating the minimum wage, while 37.7% supported an increase.\textsuperscript{85} Many of those who support an increase acknowledge the negative effects it’ll have on employment, but believe that there will still be more benefits than consequences.


\textsuperscript{84} Ibid.

The only real counter argument to the unemployment effect of the minimum wage is to argue that a minimum wage hike will lead to an increase in purchasing power in the economy, which will in turn create jobs as that income is spent. However, even assuming no adverse effects on employment, the Economic Policy Institute estimated that the 2009 minimum wage hike to $7.25 generated $5.5 billion in consumer spending, which seems impressive until you realize that it only accounts for 0.0054% of the $10.1 trillion in consumer spending that year.86

**Is the US Minimum Wage High or Low?**

The current Federal minimum wage of $7.25 does appear miniscule to many. Even the International Monetary Fund (IMF) describes the US minimum wage as “low by both historical and international standards.”87 The Huffington Post titled their story on this “America Is Globally Shamed For Its Pathetic Minimum Wage,” where they [the IMF] attacked our “abysmally low federal minimum wage.”88

But the US minimum wage isn’t as low as it seems, certainly not by international standards (historical standards will be touched on later). Since the US has a relatively low cost of living (compared to other first world nations), higher minimum wages internationally aren’t as high as they

appear. Measured using purchasing power parity (PPP), Japan’s minimum wage of $9.24 would be the equivalent of $6.29 in the US. Overall, only nine other countries have minimum wages that are higher than that of the US once PPP is adjusted for. Likewise, the US nominal minimum wage ranks 8th on the Big Mac Index.

**Effects on Youth Unemployment**

While the consensus exists that a minimum wage increases youth and low skilled unemployment, the extent of this effect is debated. Among the results from various studies are as follows:

- The American Enterprise Institute found that that increases in minimum wage between 2007-2009 (State and Federal) account for a 0.8% percentage point increase in total unemployment and a 2.8% percentage point increase in youth unemployment.

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89 Purchasing Power Parity (PPP) is a technique used to determine the relative value of different currencies. It is a means by which cost of living differences between countries can be accounted for.


91 The Big Mac index is another tool for measuring PPP across nations. The study cited in the last footnote measures the amount of minutes/hours of work it would take workers at their countries minimum wages to earn enough to purchase a big mac.

In 1982, the Journal of Economic Literature found that a 10% increase in the minimum wage reduces teen employment by 1-3 percentage points.\textsuperscript{93}

The research of David Neumark and William Wascher correlated a 10% minimum wage increase with a 1.5-1.8 percentage point decrease in on-the-job training for youth.\textsuperscript{94}

Harm to youth unemployment is particularly damning, as it can have lasting negative consequences on a would-be worker. We can picture the wage scale as a ladder that worker must develop skills to climb. What a minimum wage does is saw off the bottom rungs on a ladder, hindering a worker’s ability to even begin to climb.

According to a study by researchers at Drexel University, work experience while in adolescence can boost incomes later in life by around 20-25% (relative so someone with no work experience in adolescence).\textsuperscript{95} Further corroborating this argument, the research of Linda Leighton and Jacob Mincer found that minimum wage hikes reduce on the job training and reduce long-run income growth of young workers.\textsuperscript{96}


Mincer, Jacob and Leighton, Linda. "Effect of Minimum Wages on Human Capital Formation." The Economy of Legal Minimum Wages,
Nizalova find that the longer one is exposed to a higher minimum wage as a teenager, the less hours they work and less income they generate even until their late twenties.97

Statewide Comparisons

One way to make statewide comparisons is to compare states with their minimum wages at the Federal minimum against those with their minimum wages above it. When economist Robert Murphy ran the numbers, he found the youth unemployment rate (which he defines as age 16-19) in states with their minimum wage above the Federal minimum is 25.2%, compared to 21.5% for states with their minimum wages at the Federal minimum. Of the states with the top 5 States with the highest youth unemployment, only 1 had their minimum wage at the Federal minimum. Of the bottom 25 States with the lowest youth unemployment, 19 had their minimum wage at the Federal minimum.98

Masked Youth Unemployment

An often overlooked variable in the minimum wage debate is the effect that an increased minimum wage has on the youth labor participation rate. It may be tempting to see youth unemployment top 25% and think that this is because teenagers would rather be sitting around than working, but these types of people wouldn’t be defined as being part of

the labor force and thus wouldn’t factor into youth unemployment statistics. Charted below is the labor force participation rate among those aged 15-24 size 1980. Dots on the line signify a minimum wage hike that year.  

A study published in 2001 at North Carolina State University by Dr. Walter J. Wessels provides some exact numbers. According to his study, minimum wage hikes from 1978-1981 reduced teen labor force participation by 3.62 percentage points, 1990-91 hikes by 2.07 percentage points, and 1996-97 hikes by 1.31 percentage points.  

Note that while the model in the beginning of this chapter showed a minimum wage boosting the supply of workers, this doesn’t contradict the findings here. Theoretically, the increased

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wage would cause a short-lived spike in workers who then exit the labor force after being unable to find work.

Since youth unemployment increases during a minimum wage hike, while labor force participation decreases, this has the effect of masking the true extent of the increase in unemployment.

**International Comparisons**

Mark Perry at the American Enterprise Institute found that among Western European countries, the average jobless rate is twice as large in countries with a minimum wage as compared to those without.\(^{101}\) Note here that in this particular case, Perry is measuring overall unemployment while I’ve previously isolated my attention towards youth unemployment.

<table>
<thead>
<tr>
<th>Country</th>
<th>Minimum Wage (USD)</th>
<th>Jobless Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>11.69</td>
<td>8.9</td>
</tr>
<tr>
<td>France</td>
<td>12.09</td>
<td>11.1</td>
</tr>
<tr>
<td>Greece</td>
<td>5.06</td>
<td>27.3</td>
</tr>
<tr>
<td>Ireland</td>
<td>11.09</td>
<td>13.6</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>14.24</td>
<td>5.9</td>
</tr>
<tr>
<td>Netherlands</td>
<td>10.93</td>
<td>7</td>
</tr>
<tr>
<td>Portugal</td>
<td>4.19</td>
<td>16.3</td>
</tr>
<tr>
<td>Spain</td>
<td>5.57</td>
<td>26.6</td>
</tr>
<tr>
<td>UK</td>
<td>10.02</td>
<td>7.5</td>
</tr>
<tr>
<td><strong>Average/Median</strong></td>
<td></td>
<td><strong>13.8%/11.1%</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Country</th>
<th>Minimum Wage</th>
<th>Jobless Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>0</td>
<td>4.9</td>
</tr>
<tr>
<td>Denmark</td>
<td>0</td>
<td>7.1</td>
</tr>
<tr>
<td>Finland</td>
<td>0</td>
<td>8.1</td>
</tr>
<tr>
<td>Germany</td>
<td>0</td>
<td>5.2</td>
</tr>
<tr>
<td>Iceland</td>
<td>0</td>
<td>4.7</td>
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<td>Italy</td>
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<td>Norway</td>
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<td>3.5</td>
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<tr>
<td>Sweden</td>
<td>0</td>
<td>7.9</td>
</tr>
<tr>
<td>Switzerland</td>
<td>0</td>
<td>3.1</td>
</tr>
<tr>
<td><strong>Average/Median</strong></td>
<td><strong>0</strong></td>
<td><strong>6.3/5.2</strong></td>
</tr>
</tbody>
</table>

**Has the Minimum Wage Kept up with Inflation and Productivity?**

When someone makes the argument that the minimum wage would be “X” if it had kept up with inflation, they usually cherry pick a year when the minimum wage was at its highest. One pro-minimum wage group, when answering the question “How does the current value of the minimum wage compare to its past value?” stated that “The value of the minimum wage has fallen sharply over the past forty years. In 1968, for example, the federal minimum wage was $1.60 per hour, which translated to approximately $10.70 in 2013 dollars.”

Of course by choosing 1968 as their base year – they purposely chose the year which the minimum wage was at its highest. Additionally, they’re using the consumer price index to calculate this, which tends to overstate inflation (by ignoring the substitution effect that occurs when the price of normal goods increases). When you use the personal consumption expenditure deflator (PCE), the 1968 minimum wage is worth $8.82 in 2013 dollars. Additionally, when you adjust for the post-1950 average value of the minimum wage
using the PCE, its $6.62, which is less than the current Federal minimum wage of $7.25.102

If we really want to see how our currently minimum wage stacks up historically, let’s backtrack to 1938, when the first Federal minimum wage went into effect.

One argument you might hear is that if the minimum wage isn’t meant to be a living wage, then why did FDR (who enacted the first Federal minimum wage) state that:

no business which depends for existence on paying less than living wages to its workers has any right to continue in this country. By ‘business’ I mean the whole of commerce as well as the whole of industry; by workers I mean all workers, the white collar class as well as the men in overalls; and by living wages I mean more than a bare subsistence level-I mean the wages of decent living.

While I’ve seen some liberals claim that the remark was made when enacting the first minimum wage, the actual quote in question comes from a 1933 speech of FDR’s on the National Industrial Recovery Act.103 It wasn’t another five years till the first Federal minimum wage (that covered all workers) went into law – and that wage had a nominal value of 25 cents, which translated to $4.20 in 2014 dollars. This is hardly what liberals today consider to be a living


wage, and that $4.20 figure was calculated using the CPI which likely overstated the value of that wage.

A separate argument is that rather than keep up with inflation, the minimum wage should keep up with productivity. Since it’s largely accepted that wages are a function of productivity, wages should already naturally adjust upward as productivity increases.

According to Elizabeth Warren, this isn’t the case. As she stated in a Senate hearing:

If we started in 1960 and we said that as productivity goes up, that is as workers are producing more, then the minimum wage is going to go up the same. And if that were the case then the minimum wage today would be about $22 an hour.

She followed up by asking: “with a minimum wage of $7.25 an hour, what happened to the other $14.75? It sure didn’t go to the worker.”

There are two gaping flaws with Warren’s argument here. One, she’s cherry-picking the results of the study she’s citing, and two, productivity gains are not equal among all sectors of the economy. The study actually gave a wide range of estimates for what a productivity adjusted minimum wage would look like. These ranged from $9.22 to $21.72. Not only did Warren pick the highest estimate, she took the highest estimate and then rounded it upward.104

As for the argument regarding productivity, the Heritage Foundation has found that when we isolate the food service industry, real compensation has in fact tracked productivity. Another way to measure the same thing is by looking at unit labor costs in the food service industry.

The “unit labor cost” is a measurement calculated by dividing wages by productivity. A rising unit labor cost indicates that wages are rising at a faster rate than productivity, while a falling unit labor cost reflects falling wages relative to productivity. And in fact, when we look at unit labor costs in the food service industry, we find them rising since 1987 (when the BLS began measurements), not falling, which dispels the narrative Warren is trying to make.

Minimum Wage and Welfare

An argument that some proponents of the minimum wage make in an attempt to appeal to conservatives is that a higher minimum wage reduced the demand for government benefits. Even libertarians like Peter Thiel have advocated a higher minimum wage for this reason.

The CBO estimates that a minimum wage hike to $9 an hour would boost incomes of all families below the poverty threshold by $1 billion. They also estimate that for those with incomes between one and three times the poverty threshold, and those between three and six times the threshold would see their incomes boosted by $3 billion and

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105 Ibid. Heritage chose to measure productivity and wages in the food service industry because its an industry which disproportionately employs minimum wage workers.
$1 billion, respectively. So, based off this, let’s say that a minimum wage hike to $9 an hour reduces dependence on government aid by $5 billion (which amounts to roughly half a day of Federal government expenditures).

The same CBO report estimates that such a hike would reduce employment by between 100,000 and 200,000 workers – which are people who will be in need of government aid once they’re unemployed.

Each unemployed worker between ages 18-24 costs the government $4,100 a year in benefits plus lost tax revenue, and $9,875 for workers aged 25 to 34. If we take a middle estimate at 150,000 jobs lost, the government would save money on benefits unless it cost them roughly $33,000 per unemployed person. For that reason, this argument holds some credibility, though up to nearly 1/3rd of savings on benefits for those who had a wage hike would be eroded to pay for benefits to the newly unemployed.

Keep in mind however, that these assumptions are that each dollar in additional income reduces government aid by a dollar – which will not always be the case depending on how far a person is from the poverty line. It isn’t until someone’s family income is 6 times the poverty level that they would actually see a decrease in income from a minimum wage hike to $9 an hour – as this would disqualify

108 Ibid.
them from government benefits. And in that case, their incentives would be to work less hours, as people work to increase their incomes – not reduce them. Thus, it’s safe to work under the assumption that with the costs of the newly unemployed taken into account, the effects of a minimum wage hike on the government’s budget would be either miniscule or possibly even negative.

**Effects on Minority Unemployment**

In addition to low skilled and youth unemployment, minorities are also disproportionately impacted by minimum wage laws. Economists Thomas Sowell and Walter Williams have performed an exhaustive amount of research on the effects of minimum wages on black unemployment, which will be discussed here.

Interestingly enough, black unemployment was lower than white unemployment in the early 20th century and blacks had higher labor force participation rates, despite the poor status of race relations at that time. A single sentence from Thomas Sowell truly sums up the harm minimum wage laws have on minorities, that; “the last year in which the black unemployment rate was lower than the white unemployment rate — 1930 — was also the last year when there was no federal minimum wage law”¹¹¹ (Note that Sowell is referring to the Davis Bacon Act of 1931, which applied the minimum wage to public works projects). While previously lower than white unemployment, black

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¹¹⁰ “Effects of Minimum Wage Increase,” CBO.
unemployment rates were double that of whites by 1954. It’s reasons like this why Walter Williams refers to the minimum wage as “legislating black unemployment.”

**Would Abolishing the Minimum Wage Lead to a Race to the Bottom?**

One concern over abolishing the minimum wage is that it would lead to a downward spiral in wage rates. If the law isn’t stopping employers from paying their employees under $7.25, what will stop them from paying $2 an hour?

Obviously, since only a fraction of employees actually earn the minimum wage, the law isn’t the one thing preventing employers from short changing us. If you want to know what will prevent employers from paying $2 an hour in absence of a minimum wage, go make a Craigslist ad looking for someone to mow your lawn at that rate and see how many responses you’ll get. A lesser known law is the Fair Minimum Wage Act of 2007, which allows employers to pay employees under the age of twenty $4.25 during their first 90 days of employment, yet the fact that nearly no one has heard of this law makes a decent enough case that its seldom used.

But let’s get down to numbers. Kevin Ryan (a minor contributor to this book) had an interesting way to calculate what percentage of workers would risk having their wages fall in the absence of a minimum wage. Kevin argued that since only 1,532,000 of 145,669,000 workers earn the minimum wage, the maximum amount of workers that would be at risk is the 1,768,000. However, 63% of minimum wage workers get raises during their first year, so

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It’s extremely unlikely that these workers would see decreases in pay. This leaves 567,000 workers at risk, which is only 0.39% of the labor force (though Kevin notes that a cut in pay exceeding 20% is considered just cause and would qualify these workers for unemployment).  

Effects on Prices

While an increased minimum wage will lead to an increase in income for those who remain employed despite the increase, at least some of the increase in pay is diluted as prices increase. Research into the effect that minimum wage increases have on price is relatively fresh. While over 300 studies were published by 1995 on the effects of minimum wages on unemployment, only three had been published examining its effect on price. By 2004 however, there existed enough studies on the subject to perform a small literature review on the topic. A review of 20 studies found that a 10% increase in the minimum wage leads to up to a 4% increase in food prices (as minimum wage workers tend to disproportionately be employed in food service).

Some firms can absorb the cost of minimum wage increases by paying for the wage hike out of existing profits.

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113 The sources on these figures are:
http://jobsearch.about.com/od/unemployment/fl/good-cause-unemployment.htm
There is little evidence that firms do this however, as most “low wage firms are usually too small and too competitive to absorb the extra costs.” Roughly 2/3rds of minimum wage increases are offset by higher menu prices, though we should be grateful that this exists as a coping mechanism for business as it at least offsets some adverse effects on employment.  

**Minimum Wage as an Antipoverty Tool**

One justification of the minimum wage is as an anti-poverty tool. In theory, if we set up the minimum wage at a level where anyone who works full time at it, wouldn’t poverty be eliminated? Often overlooked here is that only 2.9% of full time workers actually live in poverty. It seems that the root cause of poverty has more to do with a lack of work than work for low wages.

Since this is the case, hikes in the minimum wage wouldn’t lift many full time workers out of poverty, but part-time workers. At a $10.10 minimum wage, the CBO estimates that 16 million workers would see increases in pay, and 900,000 would be lifted from poverty. If the minimum wage is being raised to combat poverty, we see a 94% failure rate in this scenario.

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117 Wilson, “Negative Effects of Minimum Wage Laws.”
An alternative to the minimum wage is the Earned Income Tax Credit (EITC), which does a much better job targeting the poor. For example, a single mother with two kids earning minimum wage earns a real hourly wage of $10.44 an hour with the EITC included.\textsuperscript{120}

There is some debate over whether the minimum wage and EITC are substitutes or compliments. There isn’t a clear answer on this, as each worker’s situation is different. Quoting the CBO:

Many families whose income was initially within the phase-in range of the EITC schedule would find that increased earnings led to additional EITC benefits. But families whose income was initially in the phaseout range of the schedule would find that income gains from a higher minimum wage were partly offset by a reduction in EITC benefits. And families whose income was initially between the phase-in and phaseout ranges (a range in which EITC benefits do not change as earnings rise) and remained in that range after the minimum-wage increase would see no change in their EITC benefits.\textsuperscript{121}


Regardless, the EITC doesn’t come along with adverse employment affects like the minimum wage does, and is much more accurate in first targeting and then boosting the incomes of poor workers.

**Minimum Wage Myths: Australia, Washington, and San Francisco**

Australia is often cited as an example of a country with a high minimum wage (the highest nominal minimum wage in the world) and relatively low unemployment. In 2013, Australia’s minimum wage was $15.59 in American dollars. Often neglected here is the fact that Australia has a minimum wage that it graduated by age. Someone aged 16 earns $7.55 an hour, which climbs to $10.90 at age 18, $13.17 at age 19, and the oft cited $15.59 at age 20.122

But even these wages aren’t as high as they appear. After adjusting for PPP, Australia’s high minimum wage of $15.59 would be the equivalent of earning roughly $9.77 an hour in the US.123

At home, Washington State and San Francisco are often cited as examples of minimum wage success stories. The Huffington Post “informs” us that San Francisco (with a minimum wage of $10.74) is leading metropolitan areas in small business job growth, while Washington (minimum wage

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123 Mahapatra, Lisa. "Minimum Wage And Purchasing Power Parity.” Note: This source was adjusting for PPP based on Australia having a minimum wage of $16, not $15.59, so the actual adjustment is likely a few cents less than $9.77.
wage of $9.32) is leading the states in job acceleration (rate of increase in employment).\textsuperscript{124}

Washington State has an unemployment rate of 6.1% (April 2014) while North Dakota has an unemployment rate of 2.6% (the lowest in the nation), so just because employment is allegedly increasing at the fastest rate in the nation does not mean that they have the lowest unemployment rate in the nation. Twenty eight States have unemployment rates lower than Washington State.\textsuperscript{125} As for the claim that Washington’s employment is growing at the fastest pace in the nation, Moody’s analytics doesn’t even put Washington State in the top 10 States for job growth in 2014.\textsuperscript{126}

Also keep in mind that the cost of living in Washington State is 117% of the national average,\textsuperscript{127} so when you do the math, Washington’s minimum wage of $9.32 adjusted for PPP is $7.96, which is barely higher than the Federal minimum wage.

The cost of living in San Francisco is 161.3% of the national average,\textsuperscript{128} so their minimum wage of $10.74 an hour has the purchasing power of $6.66. I suppose the devil is in the details in this case, as this is actually below the Federal minimum wage. Unemployment in San Francisco is 4.8%\textsuperscript{129} (below the national average), but since their minimum wage is actually relatively low in terms of purchasing power, this makes a stronger case for lowering or abolishing the Federal minimum wage rather than increasing it.

That aside, San Francisco’s job growth really is impressive, but it’s because of their expanding technological sector,\textsuperscript{130} a sector which accounted for 30% of their employment growth since 2010,\textsuperscript{131} and a sector hardly known for having employees toiling around for minimum wage.

Card and Kreuger

In 1994, Princeton University economists David Card and Alan B. Kreuger published a study examining the effects of New Jersey’s minimum wage hike in 1992 from $4.25 to $5.05. The study surveyed 410 fast food restaurants (in NJ and Pennsylvania, to make state by state comparisons), and found “no indication that the rise in the minimum wage reduced employment.”

While the study is still often cited, it was met with great skepticism after its initial publication. To give just one example of the attitudes towards this study when it was originally published, here’s what even Paul Krugman had to say of it:

So what are the effects of increasing minimum wages? Any Econ 101 student can tell you the answer: The higher wage reduces the quantity of labor demanded, and hence leads to unemployment. This theoretical prediction has, however, been hard to confirm with actual data. Indeed, much-cited studies by two well-regarded labor economists, David Card and Alan Krueger, find that where there have been more or less controlled experiments, for example when New Jersey raised minimum wages but Pennsylvania did not, the effects of the increase on employment have been negligible or even positive. Exactly what to make of this result is a source of great dispute. Card and Krueger offered some complex theoretical rationales, but most of their colleagues are unconvinced; the centrist view is

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probably that minimum wages "do," in fact, reduce employment, but that the effects are small and swamped by other forces.\(^{133}\)

And indeed while Krugman didn’t make any specific criticisms of the study’s methodology, his skepticism was justified. The Card/Kreuger study was later challenged by both a 1996 report from the Employment Policies Institute and a separate report by David Neumark and William Wascher for the National Bureau of Economic Research (NBER).\(^{134}\)

The Employment Policies Institute critique found that “The database used in the New Jersey fast food study is so bad that no credible conclusions can be drawn from the report.” Likewise, the NBER published a critique using payroll records (while Card and Kreuger collected data by phone) from 230 fast food joints in New Jersey and Pennsylvania and concluded that “estimates based on the payroll data suggest that the New Jersey minimum wage increase led to a 4.6 percent decrease in employment in New Jersey relative to the Pennsylvania control group.”\(^{135}\)

**Conclusion**

The consensus of economists that a floor on wages artificially increases unemployment among the young and low skilled holds true in light of the data. Not only does the minimum wage increase unemployment, it also decreases


\(^{134}\) Williams, Race and Economics p. 40-41

labor force participation. As for fiscally conservative reasons for hiking the minimum wage, the arguments in favor are shaky. For the reasons stated in this chapter, there is good reason to believe that the minimum wage is a net negative on workers and the economy as a whole.
The Burden of the Leviathan:
Government and Growth
Corey Iacono

How much government is enough, and how much is too much?

Most people would not deny that public expenditure on public goods such as infrastructure, education, a court system, etcetera contributes to greater economic growth and societal well-being. However, while government spending may be initially beneficial there is a tipping point whereas further spending harms economic growth.

In line with this thinking, classical liberals believe that the economic returns of government spending are very high up to a certain point, which they consider the optimal size of government. After government spending exceeds its optimal point, it becomes a drag on economic growth by displacing private sector economic activity. Every dollar the government taxes or borrows is one less dollar available for private sector consumption and investment. Additionally, at some point government spending redirects scarce resources from more efficient and productive uses in the private sector. In order to illustrate this theory, economist Richard Rahn of the Cato Institute developed the “Rahn Curve,” as pictured below.
In this case, the size of government is measured by public expenditure as a share of the economy (GDP). The upward sloping portion of the curve shows that initial public expenditures yield large economic gains, but after a certain point, labeled the “Optimum size of govt,” additional public expenditures lead to reduced economic growth rates. The optimum size of government is referring to the level of government spending which maximizes economic growth. The reason why economists focus on government spending as a share of the economy as opposed to government spending per capita (per person) is because the latter measure is almost useless.

The reason it is useless is because government spending is obviously going to be larger in countries with larger economies. For example, government spending per

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capita in the United States in the year 2006 was larger than in the United Kingdom, Canada, and Germany, even after adjusting for the differences in domestic prices in these countries. This is not because the United States has a larger government, rather, the U.S economy is much larger than those of the aforementioned countries. Examining government spending as a share of the economy allows us to see what percentage of a country’s economic output is being coordinated by the government. This is a much better measure of the size of government than government spending per capita and allows researchers to compare the size of government in different countries. For example, government spending as a share of GDP (the economy) in 2012 for several developed countries is shown in the table below.

<table>
<thead>
<tr>
<th>Country</th>
<th>Government Spending as % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>35.30%</td>
</tr>
<tr>
<td>Canada</td>
<td>41.90%</td>
</tr>
<tr>
<td>Germany</td>
<td>45.40%</td>
</tr>
<tr>
<td>France</td>
<td>56.10%</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>48.50%</td>
</tr>
<tr>
<td>United States</td>
<td>41.60%</td>
</tr>
</tbody>
</table>

Source: Heritage Foundation Index of Economic Freedom (2014)


One of the surprising things about this table is that the size of government in the United States is comparable to that of countries like Canada and Germany. Also, Australia has a much smaller government than the United States despite having programs like universal health care.

The best evidence of the validity of the Rahn Curve comes from the fact that countries with larger governments tend to have smaller economic growth rates than countries with small governments. For example, according to a study by economists from Duke University and Wheaton College:

[OECD] Countries where total government spending was less than 25 percent of GDP experienced an average annual real GDP growth rate of 6.8 percent. As the size of government increases the annual growth rate falls. Countries at the opposite end of the spectrum, those with governments larger than 60 percent of GDP, had an average annual growth rate of 1.4 percent.\(^{139}\)

However, this simple correlation is an observation made without accounting for other factors that determine how rapidly or how slowly an economy grows. Luckily there is a good amount of research that has been done on this subject. Recently, two Swedish economists conducted a survey of the academic literature on the relationship between government size and economic growth. The studies they examined had to meet the following criteria:

- Published in peer-reviewed journals after 2000
- Use panel data
- Focus on rich countries (i.e., EU, OECD or equally rich countries)
- Measure total government size (i.e., total taxes or total expenditure)
- Examine the effect of government size on growth of real GDP per capita

Graph Source: Connors and Norton (2012)\textsuperscript{140}

\textsuperscript{140} Ibid.
According to their analysis,

The most recent studies find a significant negative correlation [between government size and growth]:
An increase in government size by 10 percentage points [of GDP] is associated with a 0.5 to 1 percent lower annual growth rate.\textsuperscript{141}

This confirms the findings that countries with smaller governments grow faster, even after accounting for other factors which affect economic growth. However, the authors make an important note: Government spending typically increases during economic downturns. This means that the relationship could be partially driven by slow economic growth causing government spending to rise (a phenomenon known as reverse causality), not the other way around. Paul Krugman for instance, subscribes to this explanation.\textsuperscript{142}

Fortunately, three of the studies they examined addressed this issue and all three find that government size is the driving factor behind the negative relationship. Unfortunately, we can’t be absolutely positive that these studies determined the direction of causality correctly, because it’s almost impossible to do so. According to the Swedish economists:

The lack of good instruments for government size means the issue of causality has not yet been


completely settled— and is perhaps not likely to ever do so. This problem plagues many econometric studies of important phenomena, inhibiting researchers from giving reasonable causal interpretations even to strong correlations.

Still, the fact that all three studies utilized different methods of determining causality and came to the same conclusion supports the idea that government spending is in fact causing slower economic growth, leading the authors of the study to state:

The research is rather close to a consensus: the correlation [between government size and economic growth] is negative, and the sign seems not to be an unintended consequence of reverse causality.

Given this research, economists have made attempts to pinpoint the optimal size of government. In 2013, economist Livio di Matteo of the Fraser Institute, a Canadian think tank, published important research on the matter. Using data from 70 countries over the period 2000-2011 and controlling for the effects of numerous other relevant variables he was able to find that the optimal size of government is 26% of GDP. According to his analysis:

All other things given, annual per capita GDP growth is maximized at 3.1 percent at a government expenditure to GDP ratio of 26 percent; beyond this ratio, economic growth rates decline. This demonstrates that there is an optimal size for the public sector when it comes solely to the effect on economic growth... over the course of a decade, an economy with a public sector size of 30 percent could see its per capita GDP (in US PPP$) grow by over one-third, while an economy with a
public sector size of 40 percent would see smaller per capita GDP gains of only one-fifth.  

These findings are in line with prior research conducted by the Institute for Market Economics, which finds that the optimal size of government is no more than 25% of GDP for developed countries. Unsurprisingly, the authors attribute this result “to the inefficiency of allocation of scarce resources in the public sector and the crowding-out effect that government investment has on private investment”. It is also worth noting that the authors believe that their results are somewhat biased. According to the study:

\[\text{Due to model and data limitations, it is probable that the results are biased upwards, and the “true” optimum government level is } \text{even smaller} \text{ than the existing empirical study indicates.}\]

How fast economies grow determines which countries will become rich and which stay poor, so any reduction in a country’s economic growth rate is highly undesirable. Even if the reduction is small, the cumulative economic losses of having a slower economic growth rate builds over time, as evidenced by Di Matteo’s findings, which show that the economic standard of living of citizens in countries with

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145 Ibid.
small governments will grow much faster over time than those of citizens in countries with large governments.

Many will argue however, that having a small government will lead to undesirable social outcomes. But research by the Center for Policy Studies, a UK think tank, casts doubt on this claim. They find that countries with small governments, which they define as countries with government expenditure being less than 40% of GDP, have similar or better social outcomes than countries with big governments. According to the authors, small governments have better educational outcomes and higher life expectancies, while big governments have slightly lower infant mortality rates.146

The aforementioned research by Livio Di Matteo finds that the level of government spending which maximizes both economic and social outcomes to be 30% of GDP.147 Lastly, economist Antony Davies of Duquesne University estimates that the level of government spending which maximizes human development is a mere 14.7% of GDP, which is about a third of what most governments in developed countries currently spend.148

146 Bourne, Ryan, and Thomas Oechsle. "SMALL IS BEST LESSONS FROM ADVANCED ECONOMIES." Center for Policy Studies, May 2012. Web. <http://www.cps.org.uk/files/reports/original/120522105633-smallisbest.pdf>. Palumbo’s Note: The differences in infant mortality may be more to do with criterion for defining infant mortality among nations. Nearly every nation except the US classifies infant deaths within 24 hours of birth as “stillborn,” and thus they aren’t counted into the infant mortality statistics of those nations. In the US, 40% of infant mortalities are within 24 hours of birth, and are counted towards our infant mortality statistics. (See: Conscience, p. 70)
147 Ibid. citation #6
Ultimately, these findings suggest that the optimal size of government is no more than 30% of GDP, meaning that nearly all developed countries have governments which are already too large and that increasing public spending is likely to be both economically damaging and detrimental to social outcomes.

**Government Size and Employment Outcomes**

While there is a good amount of research on the relationship between the size of government and economic growth, less research has bothered examining the relationship between government size and employment outcomes. It is often assumed that government spending increases employment, but is this really the case? To answer this question two economists from the University of Delaware, Burton Abrams and Siyan Wang, used data from 20 OECD (Organization for Economic Co-operation and Development) countries over three decades and examined how government spending as a share of GDP affects the unemployment rate (when accounting for other relevant factors). Their findings are as follows:

We find that increases in government outlays hamper economic growth and raise the unemployment rate. Moreover, different types of government outlays are found to have different effects on growth and unemployment, with transfers and subsidies having a larger effect than government purchases. In addition, Granger causality tests suggest unidirectional causation from government

The authors go on to note that according to their estimates, the stimulus spending undertaken by the Federal government in 2009 actually increased unemployment:

According to our estimates, as a result of the ARRA [American reinvestment and recovery act], the U.S. unemployment rate is expected to increase by 0.3 percentage point in 2009 and by 0.7 percentage point in 2011. The negative effect on employment is expected to last until 2014.\footnote{Ibid.}

These findings are notable because they don’t just establish a correlation, they use causality tests as well and find that government spending is the cause of higher unemployment. Research conducted by economist Horst Feldmann of the University of Bath comes to similar conclusions. Using data from 19 industrial countries for the period 1985 to 2002, Feldmann analyzed how the size of the government sector affected unemployment after controlling for the impact of the business cycle as well as for the impact of labor market institutions and other factors. According to his research:

I find that a large government sector is likely to increase unemployment. It appears to have a particularly detrimental effect on women and the low skilled and to substantially increase long-term unemployment. It seems that dominant state-owned enterprises, a large share of public investment, as well as high top marginal income tax rates and the
low income thresholds at which they apply are particularly detrimental.\textsuperscript{151}

Further research by other economists comes to the same results and determines that larger governments are in fact the cause of the negative correlation between government size and unemployment.\textsuperscript{152} These results are incredibly surprising and turn conventional Keynesian economic wisdom on its head. However, as we will see throughout this book, what is considered common knowledge is often just unsubstantiated assumptions.

\textbf{The Reinhart/Rogoff Fiasco}\textsuperscript{153}

Economists Carmen Reinhart and Kenneth Rogoff published a famous study titled “Debt in a Time of Growth,” which showed that once a nation’s debt to GDP ratio hits 90\%, growth turns negative.\textsuperscript{154}

The study came under fire when Thomas Herndon, a doctoral student in economics at the University of Massachusetts attempted to replicate the study for an econometrics class – and ran into some troubles. As it turns out, some countries with high debt and high growth were excluded from Reinhart and Rogoff’s study, miscellaneous other countries were excluded, and even some basic errors

\begin{flushleft}
\textsuperscript{153} Added by Palumbo \\
\end{flushleft}
in excel were made. Herndon was quickly heralded in the media as the student who “shook the global austerity movement.”

The attitude of myself and many others on the fiscally-conservative side was probably similar to feelings those on the left had during the Climategate scandal: that there are other studies. While the leaked Climategate emails may have discredited researchers at the Climate Research Unit at the University of East Anglia, but it says nothing of the thousands of other studies on the topic of climate change. The same holds true here: Reinhart and Rogoff’s study had faults, but it wasn’t the single study leading economists to conclude that there’s a negative relationship between debt and growth - there are hundreds of other studies to examine.

Since some of those other studies have already been discussed in this chapter, it’s worth pointing out that Herndon’s research didn’t sever the link between more debt and less growth, it simply dethroned the “90%” figure as when debt causes an economy to contract. On the next page is charted Reinhart/Rogoff’s debt and growth figures alongside Herndon’s.

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<tbody>
<tr>
<td><strong>Debt/GDP</strong></td>
<td><strong>Mean</strong></td>
<td><strong>Median</strong></td>
</tr>
<tr>
<td>0 to 30</td>
<td>4.1</td>
<td>4.2</td>
</tr>
<tr>
<td>30 to 60</td>
<td>2.8</td>
<td>3.9</td>
</tr>
<tr>
<td>60 to 90</td>
<td>2.8</td>
<td>2.9</td>
</tr>
<tr>
<td>Above 90</td>
<td>-0.1</td>
<td>1.6</td>
</tr>
</tbody>
</table>

Source: Reinhart and Rogoff$^{156}$

**The Overall Tax Burden and Economic Growth**

While determining the direction of causality in the spending and growth relationship may be difficult, it turns out to be much easier for taxes. Many of the studies which were examined by the aforementioned Swedish economists also studied the effects of both taxes on economic growth. The findings for the correlation between taxes and growth is similar to that of the finding between spending and growth: most studies find an increase in tax revenue by 10 percentage points of GDP is associated with a 0.5 to 1 percent lower annual growth rate. With this in mind the authors note that:

Given that most countries have at least slightly progressive tax schedules, the elasticity of tax

revenue with respect to GDP is above unity. When growth increases, tax revenue will increase disproportionately, and the ratio of tax revenue to GDP will rise. Moreover, when the economy is booming, the taxation of capital gains and profits results in higher revenue. While both of these effects imply high taxes tend to correlate positively with rapid growth, in fact causality runs from growth to tax revenue, not the other way around... The main lesson to be learned from exploring these important mechanisms is that a negative coefficient on government expenditure in growth regressions need not imply that large government causes slower growth. On the other hand, a negative coefficient on taxes actually provides rather strong evidence that high taxes cause lower growth, because reverse causality leads us to expect a positive correlation.\textsuperscript{157}

This is in line with research conducted by Keynesian economists Christina and David Romer. According to a summary of the Romer’s research:

[The Romers] observe that legislated tax changes taken to counteract other influences on the economy, or to pay for increases in government spending, are very likely to be correlated with other factors affecting the economy. As a result, these observations are likely to lead to biased estimates of the effect of tax changes. Tax changes that are made to promote long-run growth, or to reduce an inherited budget deficit, in contrast, are undertaken for reasons essentially unrelated to other factors influencing output. Thus, examining the behavior of output

\textsuperscript{157} Ibid. citation #5
following these relatively exogenous tax changes is likely to provide more reliable estimates of the output effects of tax changes.\textsuperscript{158}

In short, the Romer’s found that tax increases were correlated with other factors which were likely to affect economic growth, making it hard for researchers to examine how taxes affected growth. In order to deal with this problem, the Romers examined tax changes that were found to be uncorrelated with economic growth, which are known as exogenous tax changes. Examining these tax changes is an accurate way to determine how taxes affect economic growth. According to the final results of the Romer’s research, a 1\% increase in government revenue as a share of the economy causes the economy to shrink by 2-3\%.\textsuperscript{159} After their research was published, several other economists published research using similar methods, which are catalogued in the following table.

\begin{itemize}
\end{itemize}
The consensus of the research using Romer-style or similar methodology seems to be that a tax increase of 1% of GDP shrinks the size of the economy by 1-3% in the short run. The aforementioned research across countries also appears to validate this finding. 

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160 Ibid. citation #14
to demonstrate that economies of countries with large tax burdens grow much slower than countries with smaller tax burdens over the long run, even when numerous other factors are accounted for.

Furthermore, a recent comprehensive review of the research on state and local taxes and economic growth in the United States found that of the 115 studies on the matter, 63% find that taxes harm economic growth and a mere 3% found that they promote it. For the United States as a whole, influential economist Gerald Scully has estimated that the optimal size of taxation to be 19.3%, which according to him would result in an economic growth rate of nearly 7% per year! Over the period he examined, 1960-1990, total taxation as a percent of GDP was around 30% on average, much higher than the optimal size of 19%, which

Policy

162 Perotti, Roberto (2011): “The effects of tax shocks on output: Not so large, but no so small either.” National Bureau of Economic Research
suggests that Americans have much to gain by reducing the overall tax burden.

**The Need for Tax Reform**

Even if the United States does not reduce its overall tax burden, there are tremendous economic benefits of simply changing the nature of taxation and how the government collects revenue. The United States tax code is universally recognized as tremendously long and convoluted. According to CCH Standard Federal Tax Reporter, the tax code has grown from 400 pages in 1913 to a staggering 73,954 pages in 2013.\(^{168}\) One has to wonder, has anyone tried to estimate the cost of simply complying with the tax code?

\[\text{Tax Complexity Keeps Piling Up}\]

![Graph showing the growth of tax code pages from 1910 to 2010](http://www.cch.com/taxlawpileup.pdf).

The answer is yes. A 2005 study by the Government Accountability Office (GAO) reported that the compliance and efficiency costs associated with the federal tax system are large (which might be an understatement). When analyzing the compliance costs of the tax system, the study noted that the lowest available estimates suggest that the cost of individual and corporate compliance with the tax code was $107 billion (which was around 1% of GDP in 2005). As noted, this is a low estimate, here are some others:

- The Cato Institute estimates that the cost of compliance with the tax code is roughly $200 billion annually.
- Art Laffer et al., estimates compliance costs to be $431 billion annually.
- Economists Jason J. Fichtner and Jacob M. Feldman estimate compliance costs to be between $67-$378 billion annually.

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• The Tax Foundation estimates that tax compliance costs for 2014 will be $391 billion.\textsuperscript{174}
• The Small Business Administration estimates compliance costs to be $159.6 billion annually.\textsuperscript{175}

While different sources have different estimates, it appears to be clear that the costs of compliance with the tax code are enormous. On top of these costs, the Government Accountability Office (GAO) finds that the most comprehensive studies on the efficiency costs associated with the US tax code estimate such costs to be around 2 to 5 percent of GDP (as of the mid-90’s), which today is around $200-$500 billion after adjusting for inflation. Even then, the GAO notes that the studies that they examined did not cover the full scope of the efficiency costs associated with the tax code. More recent research finds that the compliance and efficiency costs of the tax code result in $148-$609 billion in foregone economic growth annually.\textsuperscript{176} These numbers are large and amount to 1-4\% of US Gross Domestic Product as of 2014.\textsuperscript{177}

These findings suggest that the American economy would be growing much faster each year if the economic costs associated with the tax code were absent, which necessarily implies that the current American economic


\textsuperscript{176} Ibid. citation #30

standard of living is significantly lower than it would have been in the absence of the current federal tax code. Clearly, the United States is in need of tax reform.

**A Better Alternative: A Progressive Consumption Tax**

The goal of any tax system should be to raise sufficient revenues in the fairest, most transparent, and least economically distortionary way possible. It shouldn’t discourage productive behavior nor have countless loopholes written in for special interests. In the search for the best tax code, many economists have found themselves favoring the idea of a progressive consumption tax.

Consumption taxes of course refer to the taxation of the consumption of final goods and services. One obvious example of a consumption tax is the sales tax, which is common on the state level. The reason many economists favor a progressive consumption tax is because it taxes consumption rather than productive activities like work and investment. As former Federal Reserve Chairman Alan Greenspan has stated:

> Many economists believe that a consumption tax would be best from the perspective of promoting economic growth - particularly if one were designing a system from scratch - because a consumption tax is likely to favor saving and capital formation.\(^{178}\)

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Researchers from the Organization for Economic Co-operation and Development have empirically confirmed Greenspan’s insight, stating:

Corporate taxes are found to be most harmful for growth, followed by personal income taxes, and then consumption taxes. Recurrent taxes on immovable property appear to have the least impact. A revenue neutral growth-oriented tax reform would, therefore, be to shift part of the revenue base from income taxes to less distortive taxes such as recurrent taxes on immovable property or consumption.\(^{179}\)

Despite this evidence, many people fear that consumption taxes will ultimately hurt the poor and favor the wealthy since the poor tend to spend a much larger percentage of their income on consumption than the middle class and wealthy do. This observation is true, which is why there are means by which a consumption tax can be made progressive and in a way in which the poor pay no taxes at all. For example, the Fair Tax, a consumption tax which if implemented would replace the income tax, the corporate tax, the payroll tax, etc is designed to be progressive.

Under the Fair Tax there would be a monthly payment to all family households of U.S citizens which equals the sum of the taxes paid on purchases expected to be made up to the poverty level. This “prebate” is meant to make the tax progressive and ensure no one in poverty has to pay taxes whatsoever, unlike under the current payroll tax system in which the working poor face a tax rate of 15% (assuming the employer portion of the payroll tax is financed

by lower employee compensation, which most economists think is the case). The graph below shows the taxes paid as a percentage of annual household spending under the Fair Tax.

![Graph Source: Fair Tax Website](http://www.fairtax.org/site/MessageViewer?em_id=29461.0)

Since the Fair Tax has been seriously considered as a total replacement of the current tax code in the past, there has been a good deal of research on how its implementation would affect the U.S. economy. Almost all estimates find that economic outcomes improve significantly over those of the current tax code. Consider estimates by Arduin, Laffer, and Moore Econometrics, who find that growth in real GDP (Gross Domestic Product), employment, domestic investment, disposable income, and even consumption increase dramatically under the Fair Tax relative to the current tax code.\(^\text{181}\)

Estimates from the Beacon Hill Institute, a fiscally conservative think tank, as well as economists Laurence

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Kotlikoff and Sabine Jokisch make similar findings. Kotlikoff and Jokisch specifically estimate that the Fair Tax would reward low-income households with 26.3% more purchasing power, middle-income households with 12.4% more purchasing power, and high-income households with 5% more purchasing power.

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183 Ibid. citation #40

The Fair Tax is much simpler and more transparent than the current tax code. While the current tax code is over 70,000 pages long, the Fair Tax Act is only 133.\textsuperscript{185} The Fair Tax also doesn’t have the 200 different tax deductions and credits for individuals and corporations that the current system does.\textsuperscript{186} This is certainly a plus since research from the World Bank finds that tax simplification leads to less corruption.\textsuperscript{187}

Ultimately, a progressive consumption tax similar to the Fair Tax seems to be a great alternative to the current system that, if implemented, could raise wages, employment, and grow the economy quite significantly.

The Ideal Tax

While consumption taxes are much less harmful to economic growth than income and payroll taxes, there is still a more noteworthy alternative: The land value tax (LVT). The LVT is a tax on the unimproved value of land, meaning it disregards the value of improvements of the land such as buildings, warehouses, etc., unlike property taxes. It is also widely regarded as one of the most efficient means of taxation.

Most taxes act as disincentives. For example, the government imposes excise taxes on cigarettes in order to discourage smoking. The same disincentives apply to the taxation of income, investment, and consumption. The more


\textsuperscript{186} Ibid. citation #30


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money that is taxed away from workers, the less incentive there is for them to work. In fact, a 2008 study estimated that raising the payroll tax from 12.4% to 15% would reduce the number of hours worked per year by approximately 6%.\textsuperscript{188} Obviously, this is not a desirable outcome.

In the economist’s eyes, the ideal tax is one which does not discourage economically beneficial activities such as work and investment. The beauty of the land value tax does not distort economic decisions as others taxes do. Even if the individual in question invests in their land and improves it, their tax rate does not increase. Because of this, land value taxes do not discourage productive activities such as land development. Additionally, the LVT is progressive in nature since the ownership of land is even more concentrated than income or wealth.\textsuperscript{189} The poor and lower middle class also tend to be renters as opposed to land owners.

It’s also worth noting that the land value tax has won praise from economists of differing economic philosophies. Libertarian economist Milton Friedman once said:

There's a sense in which all taxes are antagonistic to free enterprise – and yet we need taxes. ...So the question is, which are the least bad taxes? In my

\begin{itemize}
\end{itemize}
opinion the least bad tax is the property tax on the unimproved value of land.\textsuperscript{190}

On the other side isle, progressive economist Joseph Stiglitz has stated:

Not only was Henry George [one of the famous advocates of the LVT] correct that a tax on land is non-distortionary, but in an equilibrium society ... tax on land raises just enough revenue to finance the (optimally chosen) level of government expenditure.\textsuperscript{191}

Though it’s not to be said that opposites always agree. Adam Smith supported the taxation of land,\textsuperscript{192} while Karl Marx opposed it.\textsuperscript{193}

The Corporate Tax

The corporate tax tends to be widely loved among progressive populists. After all, who better to tax than “greedy” corporations? While many people may actually think that taxing corporations is an effective way to raise revenue, many economists reject the corporate tax as a downright terrible idea. When a group of economists of different ideological stripes were asked to propose six

\textsuperscript{191} Ibid. citation #46

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economic reforms, one of such reforms was to “eliminate the corporate income tax…Completely.” 194

The logic behind their thinking is simple. Taxing corporations essentially takes money away from companies which are going to invest in building or improving capital. It also discourages domestic investment and encourages companies to invest overseas where the tax climate is more business friendly. This is especially relevant to the United States because it has the highest statutory corporate tax rate in the industrialized world with a rate of almost 40%. In fact, as this book is being written, Burger King, the famous hamburger chain, is trying to move its domicile, or place of permanent residence, to Canada for the purpose of escaping high U.S corporate tax rates.195 Even when we examine the effective corporate tax rates, which is the rate paid after tax credits, deductions, etc. have been accounted for, research still finds that the United States has corporate tax rates which are among the highest in the world, as shown on the following page.

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Once one looks at the evidence it’s hard to believe that anyone could support raising taxes on corporations. In fact, the research shows that the net effect of corporate taxation is slower economic growth and lower wages for workers. Recall that researchers at the Organization for Economic Co-operation and Development found that corporate taxes were more harmful to economic growth than any other tax. Other researchers have come to similar conclusions. The following table shows a sample of studies that examine the effect of the corporate tax on economic growth, productivity, and

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Source: Business Roundtable

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investment that published in the year 2005 or later. While there are some studies that find no effect of the corporate tax rate on economic growth, they are in the minority.

<table>
<thead>
<tr>
<th>Study</th>
<th>Method/Data</th>
<th>Effect</th>
<th>Summary</th>
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</thead>
<tbody>
<tr>
<td>Vartia (2008)</td>
<td>Examines how investment and productivity reacts to taxation using industry-level data from a set of OECD countries.</td>
<td>Negative effect of corporate and top marginal income taxes on productivity.</td>
<td>“The paper finds evidence that corporate and top personal income taxes have a negative effect on productivity. In contrast, tax incentives for research and development (R&amp;D) are found to have a positive effect on productivity.”</td>
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<td></td>
<td>Examines corporate taxes and top marginal income taxes.</td>
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<td>“The paper finds evidence that corporate and top personal income taxes have a negative effect on productivity. In contrast, tax incentives for research and development (R&amp;D) are found to have a positive effect on productivity.”</td>
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Margareta Dackehag & Åsa Hansson (2012)198

“[W]e study how statutory tax rates on corporate...”

Negative for both income and

“We find that both taxation of corporate and personal income negatively

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and personal income affect economic growth by using panel data from 1975 till 2010 for 25 rich OECD countries.”

<table>
<thead>
<tr>
<th>Study</th>
<th>Methodology</th>
<th>Results</th>
<th>Notes</th>
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<tbody>
<tr>
<td>Ferede and Dahlby (2012) 199</td>
<td>Examined the effect of corporate taxes on economic growth in Canadian Provinces (1977-2006)</td>
<td>Negative “We find that a higher provincial statutory corporate tax rate is associated with lower private investment and slower economic growth. Our estimates suggest that a 1 percentage point cut in the corporate tax rate is related to a 0.1-0.2 percentage point increase in the annual growth rate.”</td>
<td>199 Dahlby, Bev, and Ergete Ferede. &quot;THE IMPACT OF TAX CUTS ON ECONOMIC GROWTH: EVIDENCE FROM THE CANADIAN PROVINCES.&quot; Nj.tax.org. National Tax Journal, Sept. 2012.</td>
</tr>
<tr>
<td>Heady, Arnold, Brys, Johansson, and Vartia (2008) 201</td>
<td>Examined the effect of taxes on economic growth in 21 OECD countries</td>
<td>Negative “Corporate taxes are found to be most harmful for growth, followed by personal income taxes, and then consumption taxes. Recurrent taxes on immovable property appear to have the least influence.”</td>
<td>201 Johansson, Asa, Christopher Heady, Jens Arnold, Bert Brys, and Laura Vartia. &quot;Tax and Economic Growth.&quot; Organization for Economic</td>
</tr>
<tr>
<td>Source</td>
<td>Methodology</td>
<td>Findings</td>
<td>Notes</td>
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<tr>
<td>Arnold and Schwellnus (2008)(^{202})</td>
<td>Examined OECD countries over the period 1996-2004</td>
<td>Negative impact on investment</td>
<td>“The empirical analysis presented here provides evidence of substantial negative effects of corporate taxation on productivity and investment.”</td>
</tr>
<tr>
<td>Mertens and Ravn (2012)(^{203})</td>
<td>Examine personal income and corporate taxes in the United States after WWII.</td>
<td>Negative</td>
<td>“[A] one percentage point cut in the APITR [average personal income tax rate] raises real GDP per capita on impact by 1.4 percent and by up to 1.8 percent after three quarters. A one percentage point cut in the ACITR [average corporate income tax rate] raises real GDP per capita on impact by 0.4 percent and by up to 0.6 percent after one year.”</td>
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<tr>
<td>Djankov, Ganser, McLiesh, Ramalho, and Shleifer (2010)(^{204})</td>
<td>Examined effective corporate tax rates in 85 countries in 2004</td>
<td>Negative</td>
<td>“In a cross-section of countries, our estimates of the effective corporate tax rate have a large adverse impact on aggregate investment, FDI, and entrepreneurial activity.”</td>
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The research on this subject was best described in a literature review which states:

A vast analysis of the corporate income tax in countries around the world — both industrialized and developing countries — finds that the corporate income tax reduces gross domestic product (GDP) growth, reduces worker productivity, reduces domestic investment by domestic and foreign companies, and reduces entrepreneurship.205

In the United States specifically, of the 82 studies published since 1990 which have examined the effect of state and local corporate taxes on economic growth, 67% of them find that such taxes have statistically significant negative effects on growth, whereas only 9% find that they have a statistically significant positive effect on growth.206 In terms of the federal corporate tax, the Federal Reserve Bank of St. Louis estimates that a corporate tax rate of 12% would maximize the economic welfare of the United States.207

Yet another detail that advocates of the corporate tax may not be aware of is the fact that there is a large body of evidence which suggests that it adversely affects worker’s wages quite dramatically. Any tax that reduces domestic investment necessarily reduces growth in the capital stock. Slow growth in the capital stock necessarily results in slow growth in the economy.208

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growth in worker’s wages since wages are based on worker productivity (as noted earlier in this book). Those on the left may decry this as “trickle-down economics”, but the evidence appears to support this theory. For example, according to a noteworthy study published by the Congressional Budget Office, “domestic labor bears slightly more than 70 percent of the burden of the corporate income tax.”

Numerous other studies challenge the belief that the burden of the corporate tax falls solely on the shoulders of the owners of capital:

- A review of the empirical literature on corporate tax incidence conducted by the U.S Department of the Treasury found that, “labor may bear a substantial portion of the burden from the corporate income tax.”

- Economist Arnold C. Harberger has found that labor bears over 80% of the corporate tax.

- Kevin Hassett and Aparna Mathur of the American Enterprise Institute, a conservative think tank, found that for every 1 percent increase in corporate tax rates, wages decrease by nearly 1 percent.

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• Wiji Arulampalam, Michael P. Devereux, and Giorgia Maffini of Oxford University found that $1 in additional corporate tax reduces wages by 92 cents in the long run.212

• According to economist Alison Fenix, “I estimate that a one percentage point increase in the marginal corporate tax rate decreases annual wages by 0.7 percent.”213

While many people may be under the impression that investors are the ones shouldering the burden of the corporate tax, and that a tax on corporations is a tax on the rich, the evidence suggests this may not be the case. In fact, it appears as though workers bear the majority of the tax burden according to the aforementioned findings.

Facing a large corporate tax burden, investors can send their money overseas and companies can move production offshore. On the other hand, domestic workers have no such luck. They are now deprived of capital which would have raised their productivity and correspondingly their wages. On this note, economist Laurence Kotlikoff estimates that eliminating the corporate tax and replacing it with higher income taxes (or consumption taxes) would raise worker’s wages by 12-13% over the status quo.214 Of course,


214 Kotlikoff, Laurence, Sabine Jokisch, Ashwin Kambhampati, and Hans Fehr. "Simulating the Elimination of the U.S. Corporate Income
increasing consumption or income taxes would shift the entire tax burden on the workers rather than just the majority of it. In order to avoid this, it would be important to replace lost revenues from eliminating the corporate income tax with higher taxes on the wealthy, as opposed to higher taxes on everyone, or by reducing the corporate tax to a point where it is revenue neutral (which occurs at a tax rate of 9% according to Kotlikoff, or 12% according to an aforementioned estimate). Additionally:

The Tax Foundation estimates that:

Cutting the federal corporate tax rate from 35 percent to 25 percent would raise GDP by 2.2 percent, increase the private-business capital stock by 6.2 percent, boost wages and hours of work by 1.9 percent and 0.3 percent, respectively, and increase total federal revenues by 0.8 percent.215

The American Action Forum, a conservative think tank, comes to similar conclusions:

[A] statutory tax rate of at least 25 percent would be revenue neutral and would raise trend economic growth by 1 percentage point. In the near term, this would translate to roughly 1 million more jobs. Over the longer run, the beneficial effects of faster growth would accrue to workers in the form of higher income

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– an additional $10 trillion in GDP – and faster wage growth.\textsuperscript{216}

Thus, up to a certain point, there seems to be a Laffer Curve effect\textsuperscript{217} where lowering tax rates leads to faster growth (or an influx of corporate migrations), which raises revenues and offsets the fiscal effects of the tax cuts. In order to visually demonstrate the relationship between corporate tax rates and corporate tax revenues (as a \% of GDP), Chris Edwards of the Cato Institute created the following graphic.\textsuperscript{218}

![Average Corporate Tax Rates and Revenues, Average of 19 OECD Countries](source: Cato Institute)


\textsuperscript{217} This concept will be explained further later in the chapter.

The graph demonstrates that there is typically inverse relationship between the average corporate tax rate and revenue from corporate taxes (except during the time of the recent financial crisis). Of course, this is only a simple relationship so any interpretation of the graphic should be taken with a grain of salt. Still, estimates from economists seem to suggest that, up to a certain point, corporate tax cuts are self-financing and result in faster economic growth.

Those on the left probably don’t like the idea of cutting taxes for corporations, however, it’s worth noting that even President Obama has advocated a simpler corporate tax code with lower tax rates as a means to boost economic growth. In a lengthy speech the President stated:

[W]e've got to keep working to make America a magnet for good, middle-class jobs to replace the ones that we’ve lost in recent decades -- jobs in manufacturing and energy and infrastructure and technology.

And that means simplifying our corporate tax code in a way that closes wasteful loopholes and ends incentives to ship jobs overseas. And by broadening the base, we can actually lower rates to encourage more companies to hire here and use some of the money we save to create good jobs rebuilding our roads and our bridges and our airports, and all the infrastructure our businesses need.²¹⁹

Income Taxes

Income taxes are among the most harmful type of taxes since they discourage productive activities such as work and investment.\footnote{The type of investment here is different from investment in stocks, bonds, etc. which are subjected to the capital gains tax. The type of investment that the income tax would discourage would be investment in a proprietorship or in human capital.} In comparison to other taxes, research generally finds that the negative effects of income taxes on economic growth are comparable to those of corporate taxes. Of the 83 studies of state and local taxes in the United States, 67\% found that income taxes harmed economic growth and only 7\% found that they promoted it.\footnote{Hood, John. "Lower Taxes, Higher Growth." Johnlocke.org. John Locke Foundation, Apr. 2014. Web. <http://www.johnlocke.org/acrobat/spotlights/Spotlight452LowerTaxesHigherGrowth.pdf>.
}

According to research by economist Karel Mertens and Morten Ravn, a one percentage point cut in the average personal income tax rate raises real GDP per capita on impact by 1.4 percent and by up to 1.8 percent after three quarters (in the United States).\footnote{Mertens, Karel, and Morten O. Ravn. 2013. "The Dynamic Effects of Personal and Corporate Income Tax Changes in the United States." American Economic Review, 103(4): 1212-47.} Thus, it appears as though cutting income tax rates is an effective means to promote economic growth.

The Laffer Curve

Before we explore the nature of capital gains taxes, it is important for us explore the nature of the Laffer Curve. The Laffer Curve is the representation of the amount of
revenue a government can collect at certain tax rates. According to the curve, governments can collect the maximum amount of revenue at a certain tax rate. Tax rates below or above this revenue maximizing rate will result in lower revenues, as shown below. The theory behind the Laffer Curve is that at some point, high tax rates discourage economic activity which would have occurred at lower tax rates and would have yielded greater tax revenues. The tax rate which results in maximum revenue is different for different types of taxes, and the Laffer Curve is especially important to the capital gains tax. Charted below is a hypothetical Laffer Curve.


223 http://en.wikipedia.org/wiki/Laffer_curve
Capital Gains Tax 224

In microeconomics, elasticity is a measurement of sensitivity to change in prices. So is the price of butter increases, people will buy less butter and substitute margarine instead. In this example, butter is an elastic good. But a product like gasoline, which many of us have to buy a certain amount of no matter what, will not see a notable decline in purchases when its price increases. Gasoline is a classic example of an inelastic good.

Worth noting is that the concept of “elasticity” applies to taxes. Something like the payroll tax is hard to avoid, so raising the payroll tax is likely to raise revenue. But the same cannot be said of the capital gains tax, which the National Bureau of Economic Research finds “support for an inverse response of capital gains realizations to changes in their rate of taxation” 225

If we’re to imagine a Laffer Curve for various kinds of taxes, the Curve for the capital gains tax bends much earlier. One such instance of the Laffer effect in action is during the Bush era. In addition to the income tax cuts, Bush also cut the capital gains tax in 2003. For those in the bottom 40%, their capital gains tax rate was cut from 15% to 5%, while the higher brackets had their capital gains tax cut in half from 20% to 10%. But were revenues from the bottom 40% cut by 66% and from everyone else in half? Not by a long shot - investors pay close attention to the capital gains tax rate, and the cuts encouraged an increase in investment, which in turn brought more revenues.

224 Addition by Palumbo
The cuts paid for themselves, and then some, totaling $110 billion in revenue in 2006\textsuperscript{226} - which is 100\% higher than they had been in 2002 and nearly double the $63 billion that the CBO predicted would be collected \textit{without} the cut.\textsuperscript{227} It is significant that this was the CBO’s prediction before the cut since they don’t account for the Laffer effect in their estimates.

Based off of data from the 1976-2004 period, Ohio State University professor Paul D. Evans has calculated that for each percentage point shaved off of the corporate tax rate, a 10.32\% increase in revenues surfaces.\textsuperscript{228} The data also estimated the revenue maximizing point to be at 9.69\%.\textsuperscript{229}

\textsuperscript{229} Ibid.
The capital gains tax currently doesn’t factor inflation into the gains it taxes, but this is also necessary. Unlike any other tax, the effective rate of capital gains can be harsher than the marginal rate. In 2007, the value of the dollar was roughly half of what it was in 1984, which leads Richard Rahn to propose the following thought experiment: “Assume you purchased a common stock in a company in 1984 for $100 a share and sold it in 2007 for $200 a share. Have you received any “income” from the sale of the shares of stock?” The purpose of this thought experiment is to demonstrate while the clear answer to the question is “no,” the answer is still “yes” to the IRS.  

**Taxing Financial Transactions**

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230 Ibid.
<http://online.wsj.com/article/SB120053175732296095.html>  
232 Addition by Palumbo
A tax that doesn’t yet exist in the US but is often debated is a financial transactions tax. This sort of tax wouldn’t tax capital gains, but would tax the purchasing and sale of financial assets themselves.

The CBO’s analysis of the financial transactions tax is that a 0.01 tax on the value of stocks, bonds, and debt obligations would raise $180 billion in revenue from 2014-2023, or $18 billion a year. The CBO notes that “traders would have an incentive to reduce the tax they must pay by moving their trading out of the country,” but their estimates don’t build this assumption into their calculations.

Sweden tried to impose a financial transactions tax in 1984, but abolished it by 1991. Their tax was a 0.5% tax on the purchasing and sale of securities – and quickly resulted in over 90% of trades in bonds, equities, and derivatives moving their business to London. Their tax was much higher than the tax the CBO proposes, but it does go to show that there is a behavioral response to such taxes.

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234 The report states that “The additional revenues from the option would depend importantly on the extent to which trading of securities fell in response to the tax.”
Economic Inequality: Friend, Foe, or Neither?

Matt Palumbo

With the rise of the Occupy Wall Street movement, inequality came center stage as a political issue. Though much of the research on the topic predates Occupy, the movement deserves credit for bringing the issue to the nation’s attention.

Few would accept that a society without some level of inequality is possible, or even desirable. This chapter doesn’t attempt to seek what any sort of desirable level of inequality would be, but rather to dispel myths that current levels of inequality are harmful to economic growth and stability, wages, mobility, and other aspects of the economy.

Why Inequality?

The causes of inequality have been debated for centuries. Dating back to 1754 in his “Discourse on the Origin and Basis of Inequality Among Men,” Jean-Jacques Rousseau located the source of inequality to one single variable: private property. But after Communism has been tested around the globe, we know that private property is necessary for society to flourish, even if it comes at the expense of some inequality. The questions I aim to answer here are what the sources of inequality are within a capitalistic society.

236 For example, the famous chart from Thomas Piketty and Emmanuel Saez tracking the top 1%’s income share over time dates back to the early 2000s.
Differences in Skills

Some inequality will exist in any society, for the sole reason that people possess different skills, cognitive abilities, interests, levels of ambition, levels of education, and much more.

It’s well established that those with higher levels of education earn more than those without it. Those with a high school diploma earn more than those without, those with an Associate’s degree earn more than those with only a high school diploma, those with a Bachelor’s earn more than those with an Associate’s, and so forth.237

Some may intertwine education and intelligence as a single variable. While they’re often correlated, they can act independently. For instance, who would earn more money: a student at Harvard, or a student at a public university? In nearly all cases, we can expect the student at Harvard to out earn the public student. But what if the public school student is just as intelligent as the Harvard student?

This is actually quite easy to measure, just by comparing earnings by SAT scores. Those who had similar SAT scores as Ivy League students but were rejected by Ivy League schools earned similar earnings as those who accepted and completed their education at those schools.238

Gaps in income by IQ is a trend that has accelerated since

the early 1980s, and is thus playing a growing role in inequality of income.\textsuperscript{239}

**Household Size**

The Gini coefficient we see demonstrating the extent of inequality in the US measures inequality among households rather than individuals. While there is an even distribution of households among each quintile, households vary in size. There are 39 million people in the bottom 20% of households, but 64 million in the top 20%.\textsuperscript{240} Not surprisingly, there are also more workers per household in the top 20%. The top 20% of households have 2.1 workers per household, while the bottom fifth only have 0.48.\textsuperscript{241} Additionally, the top 5% of households alone contained more heads of household who worked fifty of more hours a week than did the entire bottom 20%.\textsuperscript{242}

In the year 2002, the top 20% of households earned 49.7\% of all post-tax income, compared to 3.5\% in the bottom 20%, but these numbers would be 39.6\% and 9.4\% respectively if household size was equal across quintiles.\textsuperscript{243}

**Sample Size**\textsuperscript{244}

*Forbes* Columnist Tim Worstall points to differences in population as a cause of higher inequality in the US

\textsuperscript{242} Sowell, Basic Economics, p. 217.
\textsuperscript{243} Moore, “Fairest of Them All,” pp. 38-39
\textsuperscript{244} Excerpted from pp. 133-134 of Conscience of a Young Conservative

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relative to Europe. At the micro level, in the States we see that New York is the most unequal state, and Wyoming the most equal state. Worstall says the explanation for this is quite obvious: “the larger your data set the more variance you expect to have in your data set.” We would rather expect to have greater income inequality between the 20 million people in NY State than we would in the 500,000 in Wyoming.” In fact, Wyoming is the least populated state, and New York the third most populated.

To give an example on the macro level, take the most populated country, China. Statistically China has about the same income inequality as the US does, but that excludes an enormous sum of hidden wealth in China. According to one estimate, with hidden income included, the top 10% of households in China earn 65 times more than the poorest 10%, compared to a ratio of 23:1 reported in the official statistics.

**Why the Rise in Inequality?**

Inequality probably wouldn’t be debated today if it hadn’t been on the rise. It’s well established that inequality in America has been on the rise since 1970, though it’s the causes which are commonly debated. The causes listed thus far mainly explain why we can explain some inequality to exist in a society, but don’t completely explain the rise in inequality.

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Those like Robert Reich would like us to believe the inequality is on the rise as a result of politics: mainly the decline in top tax rates under Reagan and the fall of unionization as a percentage of the workforce. Both these explanations can be quickly rejected based on the fact that the effective tax rate paid by the rich has remained fairly constant, even after the Reagan tax cuts (as Reagan also “paid for” the tax cuts by closing loopholes) and that occupational licensure has been on the rise to the extent where it offsets the decline in unions – and then some. The income boost that occupational licensure gives to workers is around 15%\textsuperscript{248} - which is the same premium unions give.\textsuperscript{249}

The main driver of inequality since the 70s is structural changes in the economy as a result of technology.\textsuperscript{250} Simply put, the demand of high skilled workers has risen. Since those with higher skills also are of higher intelligence, it should come to no surprise those with the highest IQs (120+) start to see their rises in income

\textsuperscript{248} Kleiner, Morris M., and Alan B. Krueger. "The prevalence and effects of occupational licensing." \textit{British Journal of Industrial Relations} 48.4 (2010): 676-687. It’s not entirely clear how much of this differential is attributable to unions themselves. A union paying 15\% more doesn’t mean that a worker at a non-unionized job would make 15\% more at a unionized job. Since employers hiring union labor know that they’ll be paying more, it forces them to be more selective in hiring.


growth far outpace others beginning in the 80s (previously mentioned).  

Even changes in social structures can drive inequality. The New York Times recently pointed out that the rise in single motherhood can explain a significant chunk of the rise in inequality. To quote directly, “Changes in family structure may explain anywhere from 15 to 40 percent of the increased inequality in recent decades.”

“The Natural Rate of Inequality”

Milton Friedman played a role in creating the concept of a “natural rate of unemployment.” The concept makes the point that we can always expect a certain level of unemployment in a given country for reasons not related to the overall health of the economy. For instance, a farmer will be unemployed in winter months, even while he earns a healthy income during the rest of the year. A student graduating college will be unemployed during his job search thereafter.

I propose that a similar concept can be applied to inequality. In any society, for the reasons discussed in this section, we can expect a certain level of inequality to exist for reasons that pose no threat to the economy as a whole.

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251 Murray, Income Inequality and IQ, pp. 7-9.
“Earned” and “Unearned” Inequality

Does inequality matter? The answer to that basic question depends on a very important distinction: earned vs. unearned inequality.

In a capitalistic economy free of corruption, one becomes wealthy by providing goods and services that others desire, and in turn make them richer too. Think of it like this: the only reason you purchase an item for, let’s say, $20, is because you expect the subjective benefit you gain from that item to exceed $20. Exchange only occurs because it’s mutually beneficial. So when a product is purchased from a rich individual – you may have made them $20 richer, but you subjectively became more than $20 richer in terms of utility.

Of course, the world doesn’t always work this way. We live in a country with tens of thousands of lobbyists, all of which have the ability to divert government policy in their favor. The process of increasing one’s own wealth without creating any new wealth in the process is known as “rent seeking.” Other scenarios, such as the government granting monopoly status to a business, or imposing high barriers to entry (such as taxi medallions in certain cities) are also classified as rent seeking practices. While wealth is actually created in these scenarios by those with monopoly status or a taxi driver with an expensive license, consumer surplus is heavily diminished.

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Consumer surplus is the difference between that a consumer values a good at subjectively, and a good actually costs. If I value eating a slice of pizza at $3, and the slice only costs $2, my consumer surplus is $1. Since monopolies and industries that overcome high barriers to entry (and thus face less competition) can charge much higher prices
Also worth discussing here is the fallacy of viewing the economy as a fixed pie, whereas one’s gain is at the expense of another. When people talk of how the “rich get richer and the poor get poorer” when discussing inequality, it certainly gives the impression that they’re working within this mindset. Of course, if there were truly a fixed amount of wealth in a society to be divided up among citizens, the greatest thing we would have to fear wouldn’t be the rich grabbing a larger share of the pie – it would be population growth, which would have the effect of spreading the fixed amount of wealth more thinly across society. But this is not what we see in the real world. Wealth is not simply “distributed,” it’s created.

**Inequality and Growth**

The international data supports the thesis that increasing inequality isn’t harmful, so long as it’s the result of wealth creation by the part of those at the top.

The findings of Robert Barro in the Journal of Economic Growth were that “higher inequality tends to retard growth in poor countries and encourage growth in richer places.” Numerous other studies have confirmed this observation.

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255 See:
It’s noteworthy that inequality has negative effects on poor nations – because something else poor/developing nations are known for is corruption.\textsuperscript{256} The Journal of Governance finds that “policies that reduce corruption will most likely reduce income inequality and poverty as well.”\textsuperscript{257} This confirms my earlier statements – that inequality can actually be positive when it’s a natural function of the economy – but negative when it arises from a corruption of the political process.

Surprisingly, some great myth busting of inequality myths came from Jared Bernstein in a paper he published at the progressive Center for American Progress.\textsuperscript{258} The conclusions of Bernstein’s study weren’t as concrete as Barro’s, but he did declare that “there is not enough concrete proof to lead objective observers to unequivocally conclude that inequality has held back growth.” He does continue however, that “Inequality puts at risk fundamental American precepts: the belief that hard work and fair play pays off, the conviction that the opportunities for upward mobility are available to all, and the trust in the basic fairness of American society.” Most of these arguments deal with fairness, but the argument over upward mobility is worth investigating.


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Inequality and Mobility

One argument many conservatives and libertarians advance is that inequality doesn’t matter, so long as it doesn’t come at the expense of mobility. John Stossel for instance points out that:

Today, 64 percent of the people born to the poorest fifth of society rise out of that quintile—11 percent rise all the way into the top quintile. Meanwhile, 8 percent of people born to the richest fifth fall all the way to the bottom fifth.259

And Thomas Sowell likes to point out that measuring differences in growth among income quintiles is deeply flawed, as people move in and out of quintiles all the time. To quote from Sowell:

- Of those born into the bottom quintile in 1975, 98% had higher inflation adjusted incomes by 1991, and 2/3rds had higher incomes in 1991 than the average American had in 1975.260
- Of individuals in the bottom 20% in 1975, 95% had risen out of that bracket by 1991, and 29% were in the top 20% by that year.261
- The incomes of those in the bottom 20% in 1996 increased 91% by 2005262

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260 Sowell, Basic Economics, p. 218.
261 Sowell, pp. 219-20
262 Sowell, p. 220
People move down brackets as well – especially those at the top. 75% of those in the top 0.01% in 1996 were no longer in that category in 2005.\textsuperscript{263}

In fact, most Americans will spend their lives in various income brackets. Fifty four percent of Americans will live in poverty for at least a year – but 12% will reach the top 1%, 39% will reach the top 5%, 56% will reach and top 10%, and 73% will reach the top 20%.\textsuperscript{264}

Those on the left have two points to counter this sort of argument, that 1) the US ranks poorly in terms of mobility internationally, and that 2) an inverse correlation between mobility and inequality exists.

In the first argument, mobility is being measured by the percentage of those born into the bottom 20% who rise into the middle quintile. In the USA, 42% of those born into the bottom 20% remain in the bottom 20%. While this does mean that more than half rise out, it’s low relative to other developed nations. To counter the first argument, it should be noted that comparing mobility in the US to other developed nations is comparing apples to oranges in a sense, because we define our income quintiles differently than other nations. In the US, for someone to move from the bottom 20% to the middle quintile, they’d have to earn an

\begin{footnotesize}
\begin{enumerate}
\item Sowell, p. 221.
\end{enumerate}
\end{footnotesize}
additional $22,000, but in Sweden someone would only have to earn an additional $12,500 to accomplish the same feat.\textsuperscript{265}

The second argument originated recently in a speech by Alan Kreuger. What he dubbed the “Great Gatsby Curve” measures inequality against the likelihood that a child will reach their parent’s income level. The data from Kreuger seems to indicate an inverse correlation, that as inequality rises, the likelihood that one will rise to the level of their parent’s decreases.

There are various flaws with the curve, but this particular correlation is between inequality and whether or not a person will achieve the income level of their parents, not whether or not inequality dampens the possibility of someone born into poverty rising into middle class. The richer one’s parents are, the harder it will be for them to replicate their parents’ success in terms of income,\textsuperscript{266} so the correlation is hardly surprising, even supposing no flaws with the curve.

The type of mobility I’m focusing on is mobility from poor the middle class – and that’s a type of mobility that has remained unchanged in the past half-century, despite rising inequality during that time period.\textsuperscript{267}


\textsuperscript{266} Think of it like this. Let’s say the odds of me a millionaire are one in a thousand. Even if I’m able to double my child’s chances of becoming a millionaire through whatever privileges my wealth can afford, the odds of us both being millionaires would be 1/1000 multiplied by 1/500, or 1/500,000.

Worth including in this section on income mobility is the concept of income volatility – the extent to which people’s incomes fluctuate from year to year. Volatility in income can overestimate long term trends of inequality, and indeed it has. When measuring inequality of earnings, one-third of the rise in inequality between 1970-78 and 1979-87 is the result of income volatility.268

Inheritance

The role of inheritance in society is often lumped in with the debate of wealth (rather than income) inequality. A more conservative critique of inherited wealth would emphasize the importance of pulling one up by their own bootstraps, while a more liberal critique may attack the unfairness of inherited wealth.

The moral aspect of inheritance is worth tackling before I move onto the economic case for inheritance. Is it really fair to become rich simply because a family member died? If a person was rich when they died, they were rich in the years before their death. In those prior years, would we see it immoral for them to use their wealth to benefit their family? If not, why would it be wrong for them to pass the wealth on after the grave? Likewise, the money taxed by the estate tax has already been taxed when the deceased earned that money in the first place.

In a question and answer session following a lecture by Milton Friedman, a student posed the idea of a 100%
inheritance tax as a way to raise revenues without creating any disincentives in the economy. Friedman replied:

You know the thing is that the thing that is amazing that people don't really recognize is the extent to which the market system has in fact encouraged people in the naval people to work hard and sacrifice in want I must confess I often regarded as an irrational way, for the benefit of their children. One of the most curious things to me in observation is that almost all people value the utility which their children will get from consumption higher then they value their own. Here are parents who have every reason to expect that their children will have a higher income than they ever had and they scrimp and save in order to be able to leave something for their children. I think you are sort of like a bull in a China shop if you talk about a hundred percent inheritance tax having no incentive affect. It would destroy on a continuing society.\textsuperscript{269}

This may seem like an anecdote, or more speculation, but the evidence supports Friedman’s observation. In George W. Bush’s 2001 tax plan, an abolition for the estate tax (which only lasted one year) was to go into effect in 2010. In 2001, Paul Krugman wrote that:

If your ailing mother passes away on Dec. 30, 2010, you inherit her estate tax-free. But if she makes it to Jan. 1, 2011, half the estate will be taxed away. That creates some interesting incentives. Maybe they

\textsuperscript{269} You can find a clip of the speech on YouTube at: http://www.youtube.com/watch?v=bJwUaVDIPXg
should have called it the Throw Momma From the Train Act of 2001.\textsuperscript{270}

And indeed, if Friedman’s logic is correct, so is Krugman’s in this case (a rare occurrence). \textit{Super Freakonomics} authors Steven Levitt and Stephen Dubner echoed the same type of reasoning, citing Australia, whereas a disproportionate among of people died the week after an abolition of the estate tax went into effect as compared to the week before.\textsuperscript{271}

And human nature really can’t be changed, as this sort of mindset is present in more socialist or egalitarian countries. In Sweden, the inheritance tax was initially repealed for surviving spouses starting January 1\textsuperscript{st}, 2004, but then repealed in its entirely on January 1\textsuperscript{st} 2005. Using data from taxable estates, it was calculated that those with incentives to take advantage of the repeal (as opposed to those with minor assets which wouldn’t be taxed regardless) were 10 percentage points more likely to postpone death till the day after the repeal than die the day before the repeal.\textsuperscript{272}

The estate tax also comes along with substantial enforcement costs. In his book “How Capitalism Will Save Us,” Steve Forbes cited a NBER study which found “the cost of complying with estate taxes to be one dollar for every


dollar of revenue raised." By contrast, Emmanuel Saez estimates that tax enforcement (for all taxes) consumes roughly 10% of all tax revenues, which shows just how resistant people are to the estate tax. This added to the fact that even in the absence of enforcement costs, the estate tax usually only generates 1-2% of Federal revenue in any given year shows that keeping the estate tax in effect for the purpose of raising revenue is pointless.

Greg Mankiw attracted a good deal of criticism when he headlined an article in the New York Times “How Inherited Wealth Helps the Economy.” While he doesn’t provide any statistical evidence for that title in his article, he does state that “When a family saves for future generations, it provides resources to finance capital investments, like the start-up of new businesses and the expansion of old ones. Greater capital, in turn, affects the earnings of both existing capital and workers.”

Matt O’Brien at the Washington Post categorized this argument as an “awful defense of trickle down inheritances.” But like Mankiw, O’Brien never actually gives any data about inheritance’s effect on investment.

An enormous amount of literature exists on the subject, which either author could’ve accessed and

incorporated into their arguments. The National Bureau of Economic Research found that those who either inherited or were given £5,000 were twice as likely to start a business. It’s also worth noting that inherited wealth isn’t only something that the wealthy benefit from. To quote from Kevin Williamson:

For the top income quintile, gifts and inheritances amount to 13 percent of household wealth, according to research published by the Bureau of Labor Statistics. For the top wealth quintile, they amount to 16 percent. For the hated “1 percent,” inherited wealth accounts for about 15 percent of holdings. Contrary to the story the Left likes to tell about economic inequality in the United States, those numbers have gone down over recent decades — by almost half for the wealthiest Americans. Meanwhile, inherited money makes up 43 percent of the wealth of the lowest income group and 31 percent for the second-lowest. In case our would-be class warriors are having trouble running the numbers here, that means that inherited money on net reduces wealth inequality in the United States (measured as a ratio) rather than exacerbating it; eliminating inherited wealth would have approximately twice as much of a negative effect on modest households as on wealthy ones.

So thus far we’ve seen that inheritance does help the poor and middle class, but the current estate tax only applies to estates with assets in the millions, so could an argument be made in favor of simply keeping the current system in place? Perhaps, but we’ve already seen that the cost of enforcing the estate tax merely gets us to a break-even point in terms of revenue, so it makes no sense for the tax to exist unless we have some sort of personal vendetta against the rich.

**Inequality and Wages**

A common half-truth in the inequality debate is that wages have stagnated since the early 1970s. In his 1982 book “The Case for Gold,” Ron Paul gives an early rendition of this argument, noting a decline in real wages between 1971 and 1981.278 In Paul’s case, this was to argue against the recent abandonment of the gold standard. Milton Friedman also noticed a similar pattern in his 1984 book “The Tyranny of the Status Quo”279 (though Friedman was an opponent of the gold standard, he did attribute this to the hyperinflation of the 70s).

This trend appears to have continued to present day – even as the problem of inflation has subsided. Others, like Paul Krugman will argue that inequality is responsible for stagnating wages, which have long decoupled with productivity gains.280

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278 Ron Paul, Case for Gold, p. 16. Viewed on PDF, so page in print version may differ.
The problem with this sort of argument is that workers aren’t paid in solely wages – they’re paid in wages and benefits. The percentage of compensation in the form of fringe benefits has nearly doubled in the past 40 years, so it’s intellectually dishonest to focus analysis solely on wages.

With benefits factored in, the alleged wages/productivity gap looks like this:

![Chart 1: Total Compensation Rises with Productivity](source: Heritage Foundation)

Source: Heritage Foundation


When I used the above chart in a column of mine at Rare, I received criticism for citing the Heritage Foundation on this matter. However, there are other sources which argue for an even smaller gap between productivity and compensation, such as those provided in the first chapter by Corey. The London School of Economics found that productivity only grew by 13% more than compensation since 1972 in the US, and no decoupling in the UK, which has similar inequality trends as the US.283

Reich’s Three Shifts

In Robert Reich’s documentary Inequality for All, he argues that rising inequality played a role in three fundamental shifts in the American economy. According to Reich’s narrative, as male earnings began to stagnate in the 70s, women had to enter the workforce to compensate. Then in the 90s, even two earnings weren’t enough, which forced people to work more hours. But you can only work so much – and the third shift occurred, whereas households began taking on more and more debt.

To give some background information, the labor force participation rate among women increased from 44 percent in 1972 to 58 percent in 2012. While there was a net increase in labor force participation during that time, the increased participation among women was slightly offset by declining participation from men. The stats for men were a


The biggest flaw in Reich’s argument that he overlook’s the fact that female LFP has been on the rise since the late 1940s, and actually began declining after peaking in April 2000. Regardless, it’s still worth exploring the array of variables responsible for the increase since the 1970s.

Chronicled below are various cultural and economic changes that have occurred over the past half-century which have each played a role in the rising labor force participation rate among women.

**Changing Attitudes**

Before diving into the various economic reasons for the rise in women in the workforce, it’s important to remember that attitudes on the matter have become more and more favorable. In the 1940s, 60 percent of Americans thought that women whose husbands made enough income to support their family should not be allowed to hold jobs.\footnote{Daniels, Sally, Bradford Fay, and Nicholas Tortorello. "Americans' Changing Attitudes Towards Women and Minorities." Roper Center for Public Opinion Research, Jan. 1998. Web. <http://www.ropercenter.uconn.edu/public-perspective/pps2014/91/91047.pdf>.

In 2009, Pew reported that 75 percent of Americans now reject the view that women should “return to their traditional
roles in society,” and “most believe that both husband and wife should contribute to the family income.”

**The Structure of the Economy has Changed**

At one time, America’s economy had a healthy and growing manufacturing sector. While good for the economy as a whole, many such jobs were physically demanding, which is why they were predominantly performed by men. In the economy of the 1950s, 60 percent of Americans were employed in the service sector, while that figure in 2000 stood at 80 percent. This shift has opened up new job opportunities for women.

A growing number of jobs today are also part-time, rather than full-time, and women are much more likely to work part-time jobs, while men are more likely to work full-time. In 2012, there were twice as many women employed part-time than men (26 percent vs 13 percent).

**Divorce**

How does divorce lead to more women participating in the labor force? Put simply, a now-divorced housewife can no longer afford to be a housewife. Additionally, the rising threat of a divorce occurring makes it more likely for

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women to work as a sort of “insurance” measure against the financial strain a divorce imposes.  

Divorce as a variable only explains the rise in female LFP for certain parts of our timeline. Divorce rates from the 1970s to early 2000s never fell below double the rates of the 1950s and 60s. In the late 2000s however, divorce rates have begun to fall.

**Growing Access to Contraceptives**

There is considerable evidence that access to contraceptives, the pill in particular, increased female labor force participation and hours worked. As one study in the Quarterly Journal of Economics calculated:

The estimates suggest that access to the pill before age 21 reduced the likelihood of becoming a mother before age 22 by 14 to 18 percent and increased the extent of 26 to 30 year old women’s labor-force participation by approximately 8 percent. At the intensive margin, women with early access worked at least 68 more annual hours at ages 26 to 30.

The pill was first approved for use as a contraceptive in 1960, a decade before Warren and Reich begin their measurements. However, not every woman used the pill as it became available, so it didn’t have a large impact on

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female LFP right away. Only 1.2 million American women were on the pill in 1962, but this ballooned to more than ten million by the 1980s.\(^{292}\) Thus, the pill’s effect of increasing female LDP is more evident from the 80s and beyond.

**Women have More Time to Work**

The growing availability of home appliances have freed up women’s time. Paul Krugman and Robin Wells argued this point in the second edition of their macroeconomics textbook. As they write:

…an important driving force [behind women joining the labor force] was the invention and growing availability of home appliances, especially washing machines. Before these appliances became available, housework was an extremely laborious task – much more so than a full-time job. In 1945, government researchers clocked a farm wife as she did the weekly wash by hand; she spent 4 hours washing clothes and 4 ½ hours ironing, and she walked more than a mile. Then she was equipped with a washing machine; the same wash took 41 minutes, ironing was reduced to 1 ¾ hours, and the distance walked was reduced by 90 percent.\(^{293}\)

While the particular study is from the mid 1940s, it’s relevant because home appliances have become more and more available in recent years.\(^ {294}\)


\(^{294}\) Rector, Robert, and Rachel Sheffield. "Understanding Poverty in the United States: Surprising Facts About America's Poor." Heritage
Women are Becoming More Educated

As early as 1978, women earned more associate’s degrees then men. By 1982, women earned more bachelor’s degrees then men. In 1987, women earned more master’s degrees then men, and more recently in 2006, women earned more doctoral degrees then men.295

Overall, the percentage of women earning college degrees has increased from 11 percent of all women aged 25-64 in 1970, to 37 percent of women in 2011. During the same time frame, the percentage of women who didn’t graduate high school dropped drastically, from 34 percent to 7 percent.296

This is relevant because the more educated one is, the more likely one is to enter the labor force than lesser-educated counterparts.297 Women are even more likely than men to get a job right out of college than recent male graduates.298 Since higher education means higher wages, more education

among women increases the opportunity cost of their not participating in the labor force.

**The Other Two Shifts**

What about working more hours? According to the OECD, the average American worked 1831 hours in 1990, and by the beginning of the next decade they worked 1836 hours.\(^{299}\) It’s doubtful that the average American working an additional six minutes a week fits Reich’s narrative.

Last is the argument regarding inequality and household debt. This is a thesis that the National Bureau of Economic Research has looked into and found no evidence to support. Ironically, they found the opposite, that “low-income households in high-inequality regions accumulated less debt relative to income than their counterparts in lower-inequality regions, which negates the hypothesis.”\(^{300}\)

**Inequality and Crisis**

Another argument that Reich puts forth is that inequality leads to economic crisis. Again in Inequality for All, he points out that the top 1%’s income share was highest in 1928 and 2007 – two points in time that we know were followed by sharp economic crashes thereafter. Thomas Piketty echoes this argument, stating that there is “absolutely no doubt that the increase of inequality in the United States contributed to the nation’s financial instability.”\(^{301}\) Obviously there were other recessions in between, but their

\(^{299}\) http://stats.oecd.org/Index.aspx?DataSetCode=ANHRS


severity differed, and the crashes of 1929 and 2008 stand out as financial crises.

Reich’s theory to explain this correlation is that as those at the top get richer, they begin investing in speculate assets, thereby creating a bubble which will eventually pop. We’re apparently supposed to believe that the richest among us are also the dumbest with their money.

The only problem is that before we can even create a theory to explain this correlation, we have to remember that we’re only looking at two data points. Since this sort of argumentation became commonplace following the most recent financial crisis, the NBER decided to tackle the question of the link between inequality and financial crisis. What they found was that:

Data from 14 advanced countries between 1920 and 2000 suggest these are not general relationships. Credit booms heighten the probability of a banking crisis, but we find no evidence that a rise in top income shares leads to credit booms. Instead, low interest rates and economic expansions are the only two robust determinants of credit booms in our data set.  

In the most recent recession at least, there were artificially low interest rates after 9/11, which many argue set the stage for the housing boom and bust (combined with many other factors, of course).

Another argument that inequality leads to recession stems from the “purchasing power” argument, whereas it’s

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the middle classes spending that keeps the economy in check since the rich save a larger percentage of their income and thus supposedly don’t participate in the economy. You’ll read more on why these sorts of arguments are nonsense in the chapter “Keynesian Economics in Review.” It’s noteworthy here that even Paul Krugman states that “this hypothesis has a long history — but it also has well-known theoretical and empirical problems.”

And to elaborate on Krugman’s comment, on the following page is charted the top 1%’s income share against real per-capita consumer spending.

FIGURE 4
Real per-capita consumer spending and inequality 
1947–2011

Source: Washington Post

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I wouldn’t claim that the positive correlation between the two proves anything, but rather that the lack of a negative correlation negates the “purchasing power” argument.

**Piketty in Review**

It’s not often that the conclusions of a 700-page book can be summarized in not only a single sentence, but a single equation. With Thomas Piketty’s “Capital in the Twenty-First Century,” this can be said to be the case. This equation, “r>g,” is why one writer for the Financial Times dubs Piketty “the economist who discovered capitalism's fatal flaw.” Put simply, the equation states that the rate of return on investment (after tax) exceeds growth in the economy on average, and that because of this, inequality will rise indefinitely.\(^{305}\)

I would argue that the greatest flaw with the implications Piketty draws from the equation is that it a) only holds true in the long run given that the wealthy either live for an eternity, or b) if the wealthy don’t ever exhaust any of their wealth. To elaborate on point, the fallacy of a particular gambling strategy comes to mind. This strategy is known as the martingale strategy. In games with a 50% chance of victory (i.e. a coin flip), the strategy states that you can always turn a profit from doubling your bet after a loss. If you lose a $10 bet, you can easily bet $20 the next time and turn the same $10 profit you would’ve won had you won the first bet. Of course, this strategy only works in theory when it’s assumed that the gambler has infinite wealth, as in the


\(^{305}\) Piketty, Capital, pp. 25-27.
real world there will eventually be a string of losses long enough to bankrupt the gambler.

Piketty’s equation has a similar problem. In his case, it isn’t infinite wealth assumed— but infinite lifespan. In reality, people’s spending habits can be described by what’s called the “life cycle hypothesis.” Put simply, the hypothesis states that a person’s saving happens during their early and working years, while those savings are exhausted during retirement. What good is it to accumulate wealth anyway if it can’t be spent and enjoyed?

Harvard economist Martin Feldstein confirms that this cycle (in addition to taxes on inheritance and dividing up income upon multiple beneficiaries) prevents wealth from accumulating into infinity. As he states:

The result is that total wealth grows over time roughly in proportion to total income. Since 1960, the Federal Reserve flow-of-funds data report that real total household wealth in the U.S. has grown at 3.2% a year while the real total personal income calculated by the Department of Commerce grew at 3.3%.  

Piketty does acknowledge the existence of the life-cycle hypothesis in his book, so I would only have to suppose that Piketty doesn’t believe that the wealthy will exhaust enough of their wealth during their final years. Regardless,

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307 Piketty, Capital, p. 384
Feldstein’s data showed that $r > g$ doesn’t exactly hold up in light of the life-cycle hypothesis.

For one reason or another, economists seem to have rejected the “$r > g$” explanation for the rise in inequality. The IGM Forum poll of top economists at the University of Chicago’s Booth School of Business found that when weighted for confidence, 3% of economists agree that “$r > g$”, explains the rise in inequality, while 81% “disagree,” or “strongly disagree.”

A statistic that further illustrates the failure of “$r > g$” is found in Piketty’s book itself. Piketty cites statistics from Forbes showing historical increases in wealth among the world’s billionaires since 1987. Even as wealth among the world’s billionaires has increased, those at the very top have not remained the same individuals. In his mixed review of Piketty, former Harvard president and economist Larry Summers commented that:

When Forbes compared its list of the wealthiest Americans in 1982 and 2012, it found that less than one tenth of the 1982 list was still on the list in 2012, despite the fact that a significant majority of members of the 1982 list would have qualified for the 2012 list if they had accumulated wealth at a real rate of even 4 percent a year. They did not, given pressures to spend, donate, or misinvest their wealth. In a similar vein, the data also indicate, contra

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309 Piketty, Capital, p. 432-433.
Piketty, that the share of the Forbes 400 who inherited their wealth is in sharp decline.\textsuperscript{310}

And in fact, the top 1\%’s share of total wealth has remained remarkably flat:

\begin{table}
\centering
\begin{tabular}{|c|c|c|c|}
\hline
 & Survey of Consumer Finances & Economic Policy Institute & W. Kopczuk & E. Saez \\
\hline
1962 & 31.6 & 33.4 & 24.4 \\
1983 & 31.5 & 33.8 & 21.1 \\
1989 & 30.1 & 37.4 & 22.0 \\
1992 & 30.2 & NA & 21.2 \\
1995 & 34.6 & NA & 21.5 \\
1998 & 33.9 & 38.1 & 21.7 \\
2001 & 32.7 & 33.4 & 20.8 \\
2004 & 33.4 & 34.3 & NA \\
2007 & 33.8 & 34.6 & NA \\
\hline
\end{tabular}
\caption{The Top 1 Percent's Estimated Share of Wealth}
\end{table}

Source: American Enterprise Institute\textsuperscript{311}

From 1981-1997, tax laws were changed so a larger share of capital income of high-earnings would be reported on tax returns, but the same wasn’t done for middle and lower income taxpayers.\textsuperscript{312} Due to this, we should’ve expected the

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top 1%’s share of wealth to actually be higher than it is, but it appears to have flat lined despite this.

From 1984 to 2012, balances in private retirement accounts rose from $875 billion to $12.4 trillion\(^{313}\) Since our estimates on estimated share of capital ownership come from tax returns, this wealth doesn’t show up in the data for the middle and lower class until they gradually begin to withdraw from their accounts in retirement.

The implications of \(r\geq g\) aren’t limited to only the wealthy. Kevin Williamson turned Piketty’s argument on its head in making the case for privatization of Social Security.\(^{314}\) The idea might seem scary to some (only 24% of Americans know that stocks and mutual funds are the best long term investment),\(^{315}\) but the market’s volatility in the short term doesn’t mean stocks are a risky investment in the long term. I pointed out in my last book that even someone with the worst luck in the world – someone who began investing in 1887 and cashed out in 1932 (the year of the Great Depression where the stock market bottomed out) would still have average annualized returns of 4.3%, which is a higher rate of return than Social Security today.\(^{316}\)

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\(^{313}\) Ibid. Reynolds doesn’t specify if this is inflation adjusted. If it is not, $875 billion in 1984 is roughly 1.933 trillion in 2012 dollars, using the CPI to adjust. The US population was 235.83 million in 1984, and 313.91 million in 2012, so inflation adjusted balances in private retirement accounts rose 541.5% while population only rose 33.1%.


\(^{316}\) Palumbo, Conscience of a Young Conservative, p. 187.
Ironically, Williamson points out that Piketty rejects privatization because it could put the average person at risk. But if the average person is at risk, why aren’t the rich?

**Conclusion**

It seems that much of what we know about inequality is what inequality doesn’t do. Inequality doesn’t harm growth or mobility. Inequality hasn’t caused wages to stagnate, or been responsible for our nation’s two largest economic crashes. Inequality did not force women into the workforce, force men to work longer hours, and put families into debt. And despite Piketty’s rise in fame, return on investment will not cause inequality to increase into eternity.

This chapter focusses on the alleged economic consequences of inequality, though one may argue that there exist social consequences as well. Richard Wilkinson makes the argument in his book “The Spirit Level,” that economic inequality affects a nation’s “health and social problems.” But the data only pans out for Wilkinson depending on what years you decide to choose for your data. If you use data from 2004 like Wilkinson does, there appears to be an inverse correlation between inequality and lifespan – but if you use the data from 2006 or 2009, there’s a positive relationship between the two.\(^{317}\) Similar problems are present when Wilkinson examines other issues and their correlation with inequality, such as prevalence of infant mortality, mental disorders, and crime,\(^{318}\) so this just seems to be one more thing we know inequality doesn’t cause.

\(^{317}\) Ibid., p. 294

\(^{318}\) Ibid., pp. 295-297.
Immigration Facts and Fallacies

Corey Iacono

In the United States, there has recently been a resurgence of debate on immigration reform. An immigration reform bill introduced in the Senate last year would have made it possible for undocumented/illegal immigrants to gain legal status and ultimately citizenship, as well as increase the number of annual legal immigrants permitted while adding additional border security. The nonpartisan Congressional Budget Office (CBO) estimated that these reforms would result in a net increase in the US population by nearly 10 million people by 2023 compared with the population increase under the status quo. They also found that as a result of immigration reform, “changes in direct spending and revenues would decrease federal budget deficits by about $685 billion over the 2024-2033 period”\(^{319}\). According to the Social Security Administration, immigration reform would “[add] $276 billion in revenue over the next 10 years while costing only $33 billion.”\(^{320}\)


The American Action Forum, a conservative think tank, released research which claims:

A benchmark immigration reform would raise the pace of economic growth by nearly a percentage point over the near term, raise GDP per capita by over $1,500 and reduce the cumulative federal deficit by over $2.5 trillion.\(^{321}\)

Despite these beneficial effects of immigration, people still believe that immigrants, especially undocumented/illegal ones, are a threat to the American standard of living. According to the native protectionist, immigration results in lower native wages, increases native unemployment, and are a drain on government budgets, etc. However, these beliefs are questionable and tend to collapse under scrutiny.

**Fallacy #1: Immigrants are a Net Drain on Government Budgets**

It is often claimed that if that immigrants are a large burden on government budgets and indeed, this belief has found its way into the mainstream. Liberal economist Paul Krugman has expressed fear that immigrants pose a threat to the fiscal stability of the welfare state.\(^{322}\) Libertarian economist Milton Friedman similarly believed that open borders would lead to a strain on government budgets. According to Friedman: “There is no doubt that free and open immigration is the right policy in a libertarian state, but

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in a welfare state it is a different story: the supply of immigrants will become infinite.”\textsuperscript{323} People often paraphrase Friedman in declaring that “you can’t have free immigration and a welfare state.”

Many conservatives and some libertarians invoke Friedman’s argument in order to justify closed or restricted borders, however, they fail to note that Friedman supported illegal immigration precisely because these immigrants would not be eligible for government benefits:

Look, for example, at the obvious, immediate, practical example of illegal Mexican immigration. Now, that Mexican immigration, over the border, is a good thing. It’s a good thing for the illegal immigrants. It’s a good thing for the United States. It’s a good thing for the citizens of the country. But, it’s only good so long as it’s illegal.\textsuperscript{324}

Ultimately, whether Krugman and Friedman’s concerns that open borders and looser legal immigration policies will threaten the solvency of government budgets is an empirical matter, not a purely theoretical one which is known \emph{a priori}. As previously noted, both the Congressional Budget Office and Social Security administration estimate that immigration is a net benefit for the federal budget. Additionally, according to the left of center Brookings Institute:

The consensus of the economics literature is that the taxes paid by immigrants [legal or illegal] and their descendants exceed the benefits they receive—that


\textsuperscript{324} Ibid.
on balance they are a net positive for the federal budget. 325

This is great news, but what is most relevant is immigration’s fiscal effects on all governments (federal, state, and local). In a similarly worded excerpt from a CBO study:

Over the past two decades, most efforts to estimate the fiscal impact of immigration in the United States have concluded that, in aggregate [federal, state, and local] and over the long term, tax revenues of all types generated by immigrants—both legal and unauthorized—exceed the cost of the services they use.326

The CBO study also notes that research on undocumented/illegal immigrants consistently finds that they are a “modest” net cost for state and local governments. Regardless, the net fiscal effect on all levels of government is what matters.

It’s also worth pointing out that while many people may believe immigrants come to the United States to exploit its welfare benefits, research does not support this assumption. Consider the fact that the libertarian Cato Institute found that poor immigrants and their children use

public benefits at a lower rate than the native poor.\textsuperscript{327} Also, using data from the Bureau of Labor Statistics, the conservative Manhattan Institute found that immigrants have a much higher labor force participation rate than those born in the United States (see below), indicating that immigrants come to the states to work, not to collect government benefits.\textsuperscript{328}

\begin{center}
\textbf{Immigrants more likely to work}
\end{center}

\begin{center}
\textbf{Labor-force participation rate}
\end{center}

\begin{center}
\begin{tikzpicture}
\begin{axis}[
    title={Immigrants more likely to work},
    xlabel={Year},
    ylabel={Labor-force participation rate},
    xmin=2002, xmax=2013,
    ymin=62, ymax=70,
    ytick={62,63,64,65,66,67,68,69,70},
    legend pos=north west,
    ]
    \addplot[red] table {data1.csv};
    \addplot[blue] table {data2.csv};
    \legend{Foreign-born, Native-born}
    \end{axis}
\end{tikzpicture}
\end{center}

\begin{center}
Source: Manhattan Institute
\end{center}

\textsuperscript{327} Ku, Leighton, and Brian Bruen. "Poor Immigrants Use Public Benefits at a Lower Rate than Poor Native-Born Citizens." Cato Institute, 4 Mar. 2013. Web. 19 June 2014. \\

\url{http://economics21.org/commentary/five-reasons-tea-party-should-favor-immigration}. 

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Going beyond the United States, international research makes similar findings. In 2013, Harvard Business School published a survey of the empirical research on the economic impacts of immigration in various countries. According to the authors, “on average, immigrants appear to have a minor positive net fiscal effect for host countries.”

To give a specific international example, despite Sweden’s extensive welfare state, a recent study found that the net fiscal contributions of Romanian and Bulgarian immigrants were found to be “substantially positive.”

The evidence seems to suggest that, contrary to the beliefs of opponents of looser immigration policies, immigrants tend to pay more in taxes than they receive in benefits. Thus, if anything, the net fiscal impact of immigration on government budgets is positive and small rather than negative and substantial.

Fallacy #2: Immigration Increases Native Unemployment

Another oft-cited reason to bar or restrict immigration can be summed up in the following phrase:

“They [immigrants] take our jobs!”

The belief that immigrants displace native employment assumes that there is a fixed number of jobs and ignores the well documented skills difference between

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native immigrant workers as well as the numerous ways immigrants have positive effects on employment.

First off, it were true that increasing the size of a state or country’s population lead to increased unemployment, then the long term trend of the US unemployment rate would be upward. If politicians really believed that a growing population is a bad thing, why are they actively trying to bring more workers to their states? Turn on your television, and you’ll see ads inviting you come join the “New-New York.” Turn on conservative talk radio and you’ll hear ads narrated by Rick Perry telling us that the “New-New York” is a lot like the old New York and that we should move to Texas instead. If an opponent of immigration reform believes that more immigrants will cause unemployment, they would logically have to oppose immigration between states for the same reason.

Economist Ben Powell elaborates more on this point:

If immigrants really did take jobs, on net, from existing native-born workers without new jobs also being created, the same should be true any time we add more workers to the economy. Is it? Since 1950, there has been massive entry of women, baby boomers, and immigrants into the work force. … the civilian labor force grew from around 60 million workers in 1950 to more than 150 million workers today. Yet there has been no long-term increase in the unemployment rate. In 1950, the unemployment rate was 5.2 percent, and in 2007, the year before the current recession started, the unemployment rate was 4.6 percent. As more people enter the labor force, more people get jobs.331

According to economists Richard Vedder, Lowell Gallaway, and Stephen Moore there are numerous reasons why we shouldn’t expect immigration to cause unemployment:\(^{332}\)

- From the demand side: immigrants expand the demand for goods and services through consumption.
- From the supply side: immigrants have high rates of entrepreneurship, leading to job creation.
  - Immigrants are 30\% more likely to form new businesses than U.S.-born citizens.\(^ {333}\)
  - Immigrants are more innovative than natives. “Among people with advanced degrees, immigrants are three times more likely to file patents than U.S.-born citizens.”\(^ {334}\)
- Immigrants fill niches in the low and high skilled ends of the labor market.
- Immigrants contribute to economies of scale in production of the growth of markets.

As Vedder et al. note, there is a skills gap between native and immigrant workers. Immigrant workers tend to be very poorly or very highly educated whereas US natives tend to be somewhere in the middle. Immigrants also tend to live in different locations and take jobs US natives don’t typically

http://www.econlib.org/library/Columns/y2010/Powellimmigration.htm


hold. Consider some of the following research taken from the Immigration Policy Center’s website:335

*Immigrants and native-born workers have different levels of education.*

- “According to a report from the Congressional Budget Office (CBO), nearly one-third (30 percent) of native-born workers age 25+ had some college education short of a bachelor’s degree in 2009, compared to only 17 percent of foreign-born workers. More than one-quarter (27 percent) of foreign-born workers lacked a high-school diploma, compared to only 6 percent of native-born workers.”336

- “Rob Paral & Associates found that nearly one-third (30.6 percent) of all employed recent immigrants had a bachelor’s degree or more education in 2008, compared to only 14.1 percent of unemployed natives. Over one-quarter (27.4 percent) of all unemployed natives had some college short of a bachelor’s degree in 2008, compared to only 14.4 percent of employed recent immigrants.”337

*Immigrants and native-born workers are employed in different occupations.*

- “According to the [Congressional Budget Office], the top occupation for foreign-born workers age 25-64 was construction and extraction in 2009, accounting for 8.8


336 Ibid.

337 Ibid.
percent of the total foreign-born labor force, followed by production occupations (8.7 percent); building and grounds cleaning and maintenance (8.5 percent); and sales (8.4 percent).”

- “The top occupation for native-born workers age 25-64 was office and administrative support in 2009, accounting for 13.8 percent of the total native-born labor force, followed by management (12.9 percent); sales (10.5 percent); and education, training, and library occupations (7.0 percent).”

This research demonstrates that immigrants tend to fill niche segments of the labor market in a manner which does not threaten the employment of US natives. Instead, it is likely that the specialized skill sets of immigrants complement native workers in a way which enhances economic growth. Indeed, according to research conducted by labor economist Giovanni Peri of the Federal Reserve Bank of San Francisco:

Statistical analysis of state-level data shows that immigrants expand the economy’s productive capacity by stimulating investment and promoting specialization. This produces efficiency gains and boosts income per worker…[E]vidence is scant that immigrants diminish the employment opportunities of U.S.-born workers.

Furthermore, research published by the Centre for Economic performance finds that, “the effect of immigration on native

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338 Ibid.
339 Ibid.
employment is positive." In light of the research on this subject, labor economist George Borjas has declared:

The methodological arsenal of modern econometrics cannot detect a single shred of evidence that immigrants have a sizeable adverse impact on the earnings and employment opportunities of natives.

Fallacy #3: Immigrants Reduce Native Wages

Opponents of open immigration policies, much like protectionists, seek to protect native workers from foreign competition, arguing that it will drive down native wages. In the mind of the native protectionist, an increase of the supply of labor necessarily increases the number of people competing for employment, resulting in a fall in wages in order to equilibrate supply with demand. However, as previously mentioned, research finds that immigrants tend to fill niche segments of the labor market and have specialized skills which complement those of US natives, resulting in efficiency gains and higher incomes per worker. In fact, none the research on this subject supports the conclusion that immigrants lower average native wages, consider the following:

- The Brookings Institution reports:

  Economists find that, on average, previous waves of immigrants [have] tended to boost American wages. In fact, studies have shown that immigration has caused small but positive gains in wages of American-born

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workers of between 0.1 percent and 0.6 percent between 1990 and 2006.  

- A 2014 review of the empirical literature on the matter by economists Giovanni Peri and Ethan Lewis states:

A cross a wide range of settings and research approaches, immigration is associated with higher wages for most native-born workers, and with higher productivity especially when analyzing immigration across geographic areas.  

- A study by the Economic Policy Institute, a progressive think tank, also finds that immigrants have “modest positive effects” on the wages of US born workers.  

- A factcheck.org article summarizes the academic research in this way:

There is… broad agreement among economists that while immigrants may push down wages for some [namely high school dropouts], the overall effect is

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to increase average wages for American-born workers. 346

Contrary to the popular belief, the academic research suggests that rather than immigrants being a drag on average native wages, they increase them slightly.

**Fallacy #4: Immigrants are More Likely to Commit Crimes**

It has often been assumed that immigrants are much more likely to commit crimes than those born within the United States. However, according to the research of UC Irvine professor Rubén Rumbaut:

Since the early 1990s, as the immigrant population (especially the undocumented population) increased sharply to historic highs, the rates of violent crimes and property crimes in the United States decreased significantly, in some instances to historic lows—as measured both by crimes reported to the police and by national victimization surveys.347

Immigrants are also less likely to commit crime than those born in the United States. Using US Census data, Anne Morrison Piehl, a professor of criminal justice at Rutgers University, found that immigrants have incarceration rates that are one-fifth that of natives. The Cato Institute, drawing off Rumbaut’s research, notes that:

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After examining the 2000 census data, Rumbaut found that incarceration rates among both legal and illegal immigrants from Mexico, El Salvador, and Guatemala were all less than half the rate of U.S.-born whites. Immigrants without a high-school diploma had an incarceration rate that was one-fourth that of native-born high-school graduates, and one-seventh that of native-born dropouts.\textsuperscript{348}

In contrast to these findings, a 2009 report by the Center for Immigration Studies argues that immigrants are in fact more likely to cause crime than natives. According to the authors:

New government data indicate that immigrants have high rates of criminality, while older academic research found low rates. The overall picture of immigrants and crime remains confused due to a lack of good data and contrary information.\textsuperscript{349}

However, subsequent research by sociologist Tim Wadsworth of the University of Colorado examined crime rates in various cities and found that cities with the largest influxes of immigrants had the largest drop in both homicide and robbery during the time period 1990 to 2000.\textsuperscript{350}


Wadsworth’s findings provide additional empirical support for Harvard sociologist Robert Sampson’s claim that:

[I]mmigrants [have] not increased crime, but they may be partly responsible for one of the most precipitous declines in crime that the U.S. has ever experienced [which occurred during the 1990’s].\textsuperscript{351}

Ultimately, there is a good amount of evidence that suggests that immigrants are less likely to commit crimes than natives and that immigration is associated with lower crime rates. On the flip side, there is also evidence that immigrants do have high rates of criminality. Thus, while most research seems to favor the idea that immigrants are no more criminal than the average native, one cannot be certain that this is absolutely the case. Nor can it be said with confidence that immigration increases crime.

\textbf{Fallacy #5: More Immigrants, More Liberalism}\textsuperscript{352}

Perhaps the most politicized fallacy is that more immigrants means more Democratic voters, which will cost Republicans elections. Ann Coulter has stated that “Immigrants — all immigrants — have always been the bulwark of the Democratic Party. For one thing, recent arrivals tend to be poor and in need of government assistance.” She added that “they're coming from societies that are far more left-wing than our own. History shows that, rather than fleeing those policies, they bring their cultures with them.”\textsuperscript{353}


\textsuperscript{352} Addition by Palumbo

Of course, the fact that immigrants tend to be more liberal than conservative on average says nothing about how consistently they’ll vote left of center. The Republican Party remains popular among immigrants from Vietnam and Cuba, and Bush gathered a substantial portion of the Latino vote in 2004.\footnote{Cantor, Guillermo. "Are Immigrants Really Destined to Give the GOP the Cold Shoulder?" \textit{Immigration Impact}. N.p., n.d. Web. 19 June 2014. <http://immigrationimpact.com/2014/02/10/are-immigrants-really-destined-to-give-the-gop-the-cold-shoulder/>.}

If we’re really going to let concern over how people vote determine social policy, our republic would be set back nearly 100 years. Coulter made the case against women’s suffrage (yes, really) by stating that if only men would vote, Republicans would’ve won every election except in 1964.\footnote{Ann Coulter, Xavier University, September 6th 2007} Of course, this is expressing the same faulty logic that she’s making in regards to immigration. If it were really the case that Republicans would win every election had only men voted, why didn’t Republicans win every single election before women were granted the right to vote?

\textbf{The Economic Case for Worldwide Open Borders}

Great libertarian thinkers such as Milton Friedman and Ludwig von Mises believed that the free movement of people across borders was desirable in the same way that the free movement of goods and services was desirable. From a libertarian standpoint restrictions of movement are necessarily a restriction of liberty. From an economic standpoint freedom of movement allows people and resources to be allocated to their most productive uses. As von Mises wrote in his influential book \textit{Liberalism}:  

\footnote{354 \footnote{355}}
There cannot be the slightest doubt that migration barriers diminish the productivity of human labor. Considering the all the aforementioned research documenting the fiscal and economic benefits of immigration, the reader will be unsurprised to learn that the loosening of border restrictions contributes to economic growth in a manner which is substantially positive. Several economists have actually published research which estimates the effect a global open borders policy would have on the size of the global economy.

According to a literature review on the subject, studies find that a global open borders policy could lead to a permanent increase in the size of the global economy by an astounding 50-150%. The author of the review attributes this tremendous increase in the size of the global economy to increased labor mobility, which allows labor (workers) to move to geographic regions with greater amounts of capital, making them more productive, resulting in higher wages.

Economic growth is key to poverty reduction, as research attributes 75% of the income gains accruing to the bottom 40% of income earners in 118 countries a result of economic growth. These findings suggest that a global open borders policy could lead to the eradication of global

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poverty as we know it. While a global open borders policy may not be a politically feasible goal,\(^{359}\) this evidence suggests that taking even minor steps toward such a goal, such as easing the process of immigration, could yield tremendous economic benefits to the world as a whole. In short, Mises was right.

However, while open borders may be desirable from an economic standpoint, such a policy may be undesirable from a national security or public health standpoint, which is a caveat worth keeping in mind.

**Conclusion**

There is a great amount of evidence which dispels the beliefs that immigrants are detrimental to the economic and social wellbeing, as well as financial sustainability of a country. There is also a great amount of evidence suggesting that open immigration policies lead to rising native wages, increased solvency of government budgets, and stronger economic growth. Throughout this chapter, research from individuals and think tanks that are self-professedly libertarian, conservative, or liberal have been cited, demonstrating the fact that people of all ideological stripes can stand with liberalized immigration policies. However, while the economic benefits of immigration seem clear, the social costs of immigration are less so, with research having somewhat mixed findings on the relationship between immigration and crime. Ultimately, from a financial and economic standpoint, it does not seem wise, nor

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\(^{359}\) By open borders, we don’t literally mean free immigration, no strings attached, but a much simplified immigration process, whereas a potential immigrant would be screened for diseases, radical political affiliations, and criminal conduct in their own country. It could also be appropriate to make some new immigrants under this system ineligible for welfare benefits for a set period of time after immigration.
humanitarian, to restrict immigration and engage in closed border policies.
Keynesian Economics in Review

Matt Palumbo

John Maynard Keynes went down in history as the most influential economist of the 20th century. Keynes once stated that “practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist,” but as the founder of modern Macroeconomics, Keynes might as well have been speaking of himself.

The main concepts we learn in macroeconomics, the multiplier, national income accounting, aggregate demand, sticky wages, the benefits of deficit spending, and many others all originate with Keynes.

Many concepts created by Keynes have merit to some extent. The purpose of this chapter is to critique many Keynesian ideas used to justify activist government by pointing out flaws in Keynesian reasoning and in the practice of Keynesian policy.

The Emphasis on Consumption

In the eyes of John Maynard Keynes, “consumption – to [state] the obvious – is the sole… object of all economic

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activity.” While Keynes was probably exaggerating his view, Keynesians today will argue that consumption accounts for 70% of the economy, since consumption does in fact make up 70% of GDP. A closed economy’s GDP is composed of consumption, investment, and government expenditure, represented by the equation $Y = C + I + G$. When Mark Skousen attacked the “70%” figure in his 2007 book “The Big Three in Economics,” the weighted figures composing the economy were as such.$^{362}$

$C = 70\%$

$I = 12\%$

$G = 18\%$

As Skousen points out, GDP only measures the value of final goods and services in the economy.$^{363}$ So let’s say your job involves delivering books from a printing press to a bookstore. This transaction isn’t accounted for in GDP, while the final sale (the books selling) is. Because of this, GDP fails to accurately account for various steps in the economy. In this example, the consumer purchase of the books increases C’s role in GDP, but the business to business transaction doesn’t counterbalance C even though the books wouldn’t be sold without that step.

Skousen created his own measurement called gross domestic expenditures (GDE) to measure the economy in all stages of production. Under this measurement, consumption only accounts for roughly a third of the economy, while

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$^{363}$ Ibid.
business spending (which Skousen defines as “investment plus goods-in-process spending”) accounts for more than half of economy.\textsuperscript{364}

**The Multiplier**

What happens when a dollar is spent? Let’s say I spend a dollar on a loaf of bread, and now the baker has $1. Maybe he’ll save 20 cents and spend the rest on a bottle of water. Now that seller has 80 cents. Maybe he’ll save 10 cents and spend the remaining 70, which in turn becomes someone else’s income.

Above is the logic of the multiplier in simplest form: that spending sets in effect a cycle. Since the multiplier is based on a consumer driven view of the economy, savings reduce the multiplier, while spending increases it. The percentage of income spent is known as the “Marginal Propensity to Consume” (MPC) while the percentage of income saved is known as the “Marginal Propensity to Save” (MPS).

The formula for the multiplier taught in introductory economics classes is $1/(1-MPC)$ or $1/MPS$. So at a MPS of .2 (meaning 20% of income is saved), we have a multiplier of five, and thus one dollar of spending yields $5 in benefit. The formula conflicts with reality. Let’s take the US economy as an example. The savings rate in the US was 3.9% in 2012,\textsuperscript{365} while the Federal Government spent 3.59 trillion that year. Had the formula for the multiplier held accurate, we can divide 3,590,000,000,000 by .039 and

\textsuperscript{364} Skousen, Big Three in Economics, pp. 182-83.

expect government spending to have added over $92 trillion to GDP that year, which is a number higher than world GDP that year.\textsuperscript{366}

But this doesn’t necessarily disprove that a multiplier exists. There are plenty of other factors that decrease the multiplier, which even Keynes acknowledged. Aside from savings, some income is spent on imports (which doesn’t help domestic employment), some money is spent on excess supply which won’t be replaced with new goods, and some income is used to pay off debts.\textsuperscript{367} Keynes referred to these things as “leakages.”

Also, because savings reduce the multiplier, while Keynes acknowledged that tax cuts also created a multiplier effect, he argued that they led to a smaller multiplier than government expenditures did, because some percentage of a tax cut is saved.

In reality however, the multiplier doesn’t play out as planned. The NBER’s analysis of the most recent recession estimated the government multiplier between 0.5 and 1 - which led to the conclusion that each job created by the stimulus came with a price tag between $170,000 and $400,000. With stimulus funds to education excluded, the multiplier was boosted to 2, but this still came at the cost of a little under $100,000 per job created.\textsuperscript{368} The estimates of Harvard professor Robert Barro (who is also the third most

\begin{footnotesize}
\textsuperscript{366} http://databank.worldbank.org/data/download/GDP.pdf

\textsuperscript{367} Hazlitt, Henry. \textit{The Failure of the "new Economics": An Analysis of the Keynesian Fallacies}. Auburn, Ala.: Ludwig Von Mises Institute, 2007. P. 138

\end{footnotesize}
cited economist of all time)\textsuperscript{369} were a “spending multiplier of around 0.4 within the same year [the stimulus was passed] and about 0.6 over two years. Thus, if the government spends an extra $300 billion in each of 2009 and 2010, GDP would be higher than otherwise by $120 billion in 2009 and $180 billion in 2010.”\textsuperscript{370}

But what about tax cuts? Keynesian logic states that they should be less simulative than spending cuts, but even Keynesian economist Christina Romer admits that “Basic accounting predicts spending increases should have a larger impact. Some of a tax cut will likely be saved, whereas all of a spending increase gets into the system,” but that “we don’t yet have the strong empirical evidence to back up or contradict this intuition”\textsuperscript{371}

Current research has challenged the traditional belief that tax cuts are inferior as an economic stimulant. Focusing on all OECD nations from 1970-2007, the NBER concluded that

**Fiscal stimuli based on tax cuts are more likely to increase growth than those based on spending increases.** As for fiscal adjustments, those based on spending cuts and no tax increases are more likely to reduce deficits and debt over GDP ratios than those


based on tax increases. In addition, adjustments on the spending side rather than on the tax side are less likely to create recessions.372

Turn on the news and you’ll hear about the failure of European austerity, but most of Europe’s austerity measures have emphasized tax increases while keeping the size of government either constant or increasing.373

In addition to tax cuts for all workers, creating tax incentives for employers to employ is also a workable stimulus measure. In Singapore, during times of high unemployment, employers have their share of the payroll tax reduced, which lowers the cost of hiring.374 Bryan Caplan points out that even if the demand for labor has a relatively low elasticity of -0.4, a one percentage point reduction in an employer’s share of the payroll tax will increase employment by 0.4 percentage points.375

A consequence of fiscal policy acknowledged by Keynes was that of a “crowding out” effect, whereas job creation by government in one area displaces job creation in another. Keynes wrote that “if, for example, a government employs 100,000 additional men on public works, and if the

374 An employer’s labor costs are more than the cost of the wage they pay out. Whatever you pay in payroll taxes each week, your employer also matches and pays.
multiplier is 4, it is not safe to assume that aggregate employment will increase by 400,000.” Keynes still believed that fiscal policy was a net positive, but that some of its benefits would be drowned out by this effect.

The real crowding out effect we should worry about isn’t just the short term crowding out effect, but crowding out in the long run. Each dollar the government borrows has to be paid back – with interest. One NBER paper published in 2008 found that:

...a 2 percent increase in government spending will—under the best scenario—lead to a less than 2 percent increase in GDP in the short-run. Eventually, however, the tax increases needed to finance this spending will result in a more than 7 percent contraction in GDP.377

As the chart below from professor Antony Davies shows, increases in government spending are associated with declines in real GDP growth, not increases (and this is in the short run).

A point that Davies makes in the paper the above chart is cited from is that the government is bad at timing stimulus efforts in response to a recession. Since a recession is defined as two quarters of negative GDP growth, we can’t logically know that the economy is in recession until we’ve been in one for six months. Thus, even if stimulus spending were effective, there would be a minimum delay of six months before we can try to counteract the recession, though political conflict may delay this even more. Even then is no guarantee that this money will be spent in the most economically depressed areas.

Source: Antony Davies

Economists of the “public choice” school argue that political incentives will take priority in the distribution of stimulus funds. Historian Burton Folson Jr. pointed out in his book New Deal or Raw
Luckily, the economy already has what we call “automatic stabilizers,” which go into effect before we even know there’s a recession. These stabilizers mainly take form as transfers, primarily as unemployment benefits.\textsuperscript{380} The International Monetary Fund finds them to be more effective than fiscal stimulus, but a disclaimer is that they do conclude that they need to be larger in the US to stabilize income and sooth consumption.\textsuperscript{381} It may be a worthwhile tradeoff to have stabilizers be larger in value in the short run but expire sooner than they currently do, as stabilizers can provide the economy with short term liquidity effects but discourage employment when extended beyond a reasonable period of time.

**The Paradox of Thrift**

The paradox of thrift is the key anti-savings doctrine of Keynesian economics, and reinforces the logic behind both the emphasis over the importance of consumption and the logic of the multiplier.

How could anyone be against savings? Keynesians will often invoke the fallacy of composition here to explain the logic. The fallacy of composition points out that what is good for one person is not necessarily good for everyone else. In this case, saving money is good for the individual doing the saving, but bad for everyone else as they’re

\textsuperscript{380} The IMF lists five components of stabilizers, which are the income tax, social security contributions, corporate tax, indirect taxes, and unemployment benefits.


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deprived of income, because everyone’s spending is someone else’s income.

What exactly are savings? “Savings” in today’s economy are not simply dollars left in a mattress, sitting idly by. They are, as Henry Hazlitt puts it, “only another form of spending,”382 because savings today simply means more consumption tomorrow.

Many justify higher taxes on the rich because they believe the rich spend a lesser percentage of their income, and thus contribute less to the economy. While a person’s MPS will increase as their income increases, there’s a negative correlation between net worth and the percentage of their savings being cash. Those with a net worth between $1-2 million have 7.5% in cash/cash equivalents, while that percentage drops to 4.1% for those in the $5-10 million category, and down to 3.1% for those with a net worth over $10 million.383 What this means is that the rich have most of their wealth not sitting around as cash, but in the form of assets or investments, the latter of which would be a positive for economic activity.

**Saving and the Cause of Recessions**

Had the assumptions of the paradox of thrift proved correct, we can expect to see large declines in consumer spending before and during recessions. Charted below is patterns in consumer spending and investment spending during recessions:

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382 Hazlitt, Economics in One Lesson, p.162
As the historical data shows, declines in investment, not consumer spending, are the main feature of a recession. The work Milton Friedman won his Nobel Prize for was titled “The Theory of the Consumption Function,” and one main insight in the work was that consumption patterns are relatively stable. What Friedman coined the “permanent income hypothesis” states that a person’s consumption patterns aren’t influenced solely by income, but also by expectations of future income. According to Friedman, individuals will consume a constant portion of their permanent income. Another hypothesis which explains stable consumption patterns is the life cycle hypothesis, which was explained in my discussion of Piketty’s “Capital.”

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There’s good reason so believe that declines in consumer spending during recessions are a symptom of the problem, not a cause. Consider a scenario like this:

One entrepreneur sells hot coffee in the scorching desert. Another sells iced coffee nearby in the freezing cold. Between two coffee businesses is a diner, where many employees of both coffee shops go after work. Both stores get some traffic, but they were bad investments. Who wants hot coffee when they’re hot, and iced coffee when they’re freezing? Eventually, both businesses will fail. As a result, the diner will suffer as well, because former employees of the coffee shops no longer have income to spend there. It may be tempting to point at the diner’s problem as being a simple lack of sales, but the root cause of this problem was malinvestment.

It’s important to remember that economies flourish because of how much we can produce. After all, we can’t consume until we’ve produced. As was mentioned in the beginning of this chapter, investment is the main driver of the economy when measured correctly. Further confirming that investment is the main driver of economic growth is the fact that countries with more savings have larger increases in per-capita GDP growth. On the following page is a chart constructed with data from The World Bank:
The Philips Curve presents another counterintuitive theory: that some level of inflation is good for the economy. While we often think of inflation as negative for obvious reasons, the Philips Curve argues that a higher level of inflation reduces unemployment. Charted on the following page is a sample Philips Curve, with a few data points plotted to illustrate the relationship.
When the economy expands, unemployment falls, and wages rise. As workers spend more, prices will rise as a result of increased demand. The opposite occurs in a recession or depression. Unemployment increases, wages decline, and in order to sell in these conditions suppliers must lower prices.

The logic of the curve assumes that inflation (in many cases) is the result of higher demand for goods, and thus, higher inflation would lead to higher levels of production, and therefore reduce unemployment. The Philips Curve is often cited to make the case for the Federal Reserve expanding the monetary supply, and therefore increasing inflation. However, inflation from increased demand (which in theory should only occur if increases in

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demand outpace increases in supply) is the result of market activity, while inflation from the Federal Reserve is artificially created. Not only that, proponents of inflation are confusing a symptom with a cause. Inflation may be a symptom of a growing economy, but it certainly isn’t the cause.

Milton Friedman had various criticisms of the curve. The first is that the results higher inflation begats aren’t fixed. In other words, 5% inflation doesn’t guarantee 3% unemployment, 6% inflation doesn’t guarantee 2% unemployment, etc.\(^{387}\) Friedman argued that it’s only *unanticipated inflation* that led to a short run decline in unemployment, but once people begin to anticipate inflation then contracts between a worker and employer will account for this.\(^{388}\)

Friedman also noted that because workers would expect inflation, more and more inflation would be needed to attain the same effect – a phenomenon he likened as given drugs to a drug addict, where a larger dose is needed to attain the same high.\(^{389}\) Friedman (emphasis his) continues that:

> the reluctance of the monetary authorities to increase the doses as much as would have been needed to get the same boost in employment is one reason why successively *higher inflation has been associated*

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\(^{388}\) Ibid, pp. 5-6.

with higher unemployment on the average, not lower unemployment.\textsuperscript{390}

The Philips Curve was established in a paper published in the 50s by Alban Philips which examined unemployment and inflation in the UK from 1861-1957,\textsuperscript{391} but modern data from the US and even the UK doesn’t establish such a relationship.

Source: BLS

\textsuperscript{390} Ibid.

It seems that the relationship established by Philips was a coincidence of history, caused by the data available to him at the time.

It’s worth mentioning that while the Curve is associated with Keynesian thought today, it’s merely part of modern Keynesian thought. Keynes himself was skeptical of inflation, writing that:

By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method they not only confiscate, but they confiscate

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arbitrarily; and, while the process impoverishes many, it actually enriches some.\textsuperscript{393}

Who are those that inflation enriches? A common argument in favor of inflation is that it reduces the debts of debtors, which helps the lower classes at expense of the upper class. But Keynes writes that:

As the inflation proceeds and the real value of the currency fluctuates widely from month to month, all permanent relations between debtors and creditors, which form the ultimate foundation of capitalism, become so utterly disordered as to be almost meaningless; and the process of wealth-getting degenerates into a gamble and a lottery.\textsuperscript{394}

Inflation impacts rich and poor in more ways than just loans. When the Federal Reserve increases the money supply by purchasing government securities, a process known as quantitative easing, it has the effect of increasing stock prices. Inflation (or the threat of coming inflation) forces people to put their money into stocks rather than lower yielding investments to earn a decent return, which acts as a self-fulfilling prophecy, boosting stock prices in the process. Keynesians should be informed that their much-hated top 1\% owns half of all financial assets, so this is a case where inflation benefits the rich, and by an extremely disproportionate amount.

To briefly revisit the argument that inflation reduces the debt burden of the poor, this claim ignores the fact that contracts can set interest rates based on anticipated inflation, so it’s only inflation higher than anticipated that would

\textsuperscript{393} Keynes, Economic Consequences of the Peace, p. 220.
\textsuperscript{394} Ibid.
reduce the poor’s real debt. Regardless, wages don’t always adjust to inflation right away, so some of the savings from inflation in regards to debt would be offset by losses in real wages in the gap period before wages adjust.

Not only that – inflation is a tax, and a regressive one at that. Inflation is an average – so inflation on certain goods rises at different paces as others. Food prices might rise at a pace above the official rate of inflation, while the prices of technology (computers in particular) declines quickly over time. So the question to ask is whether or not the kinds of goods that the poor buy are disproportionately affected by inflation, and indeed they are.

As The Economist noted regarding inflation in 2011, inflation concentrated on the prices of food and energy, which the poor tend to spend a disproportionate amount of their income on. As such, “the poorest quintile suffered an inflation rate of 4.3% between 2008 and 2010, the richest [suffered] 2.7%.”

Forbes columnist Louis Woodhill showed that using data from 1951-2012, the economy performed best during periods while the dollar was stable. He divides the years he’s working with into four periods: stable dollar (1951-1969), falling dollar (1970-1980), rising/semi-stable dollar (1981-2000), and falling dollar (2001-2012). The strength of the dollar is measured relative to its value in gold. The results are tabled below. Note that average unemployment rate for the years 2002-2012 adjusted for the decline in the labor

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force participation rate stemming from the previous recession.

<table>
<thead>
<tr>
<th></th>
<th>Average Real GDP Growth Rate</th>
<th>Average Unemployment Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stable Dollar (1951-1969)</td>
<td>3.92%</td>
<td>4.6%</td>
</tr>
<tr>
<td>Falling Dollar (1970-1980)</td>
<td>2.89%</td>
<td>6.44%</td>
</tr>
<tr>
<td>Rising, Semi-Stable Dollar (1981-2000)</td>
<td>3.4%</td>
<td>6.3%</td>
</tr>
<tr>
<td>Falling Dollar (2002-2012)</td>
<td>1.75%</td>
<td>7.42%</td>
</tr>
</tbody>
</table>

Source: Forbes[^396]

Additionally, asset productivity rose during the years the dollar was stable and semi-stable, but fell during the “falling dollar” periods.[^397]

When answering the question of why low inflation is something to be feared, Paul Krugman writes that “it [inflation] discourages borrowing and spending and encourages sitting on cash.”[^398] But we’ve seen already that the data shows real GDP to grow faster in periods of stability, and since investment is the main driver in economic growth.


[^397]: Ibid.

growth, it’s hard to believe that this signifies a lack of borrowing during those periods.

None of this is to say that deflation would be a good alternative either. Some Keynesians argue that deflation will lead to a “deflationary spiral,” whereas people postpone purchases, which requires businesses to cut their prices even further to sell their product, which in turn just reinforces the downward spiral as people continue to postpone purchases for even cheaper goods. This isn’t a reason to oppose deflation, as there are very few products that people refuse to buy because they’ll simply be a percent cheaper in a year. And deflation resulting from increased production and competition isn’t harmful either, but deflation from a contraction in the money supply is. As one writer puts it:

Consider a drastic decrease in the supply of money, say 20% (during the great depression the money supply dropped 33% over three years). The problem is not that prices will fall eventually, the problem is that inflation/deflation takes around 9-15 months before the economy will start to feel these effects. With this being considered, within the minimum of 9 months we would have only 80% of the previous money supply while prices have yet to drop. This has various implications, but clearly with less money to go around there will be less investment by businesses, less consumption by the consumer, less lending by banks etc. The economy will slow down because of this.  

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So which of the two evils do we choose, inflation or deflation? In this case, neither. As already established, stable prices are the best for the economy. As for achieving the goal of stable prices, Milton Friedman solved this problem rather simply: increase the money supply by long run economic growth. The Federal Reserve wouldn’t even be needed for this – Friedman proposed doing so through a computer program. Friedman’s estimate for the appropriate increase would range something between 2-5% a year, though given GDP growth over the past half century, around 3% might be the best figure.

There would be slight inflation some years, and slight deflation some years, but long run inflation or deflation would be close to zero. Another effect that this has is that it undermines the paradox of thrift. Can both savings and real income rise simultaneously, even though everyone’s income is dependent on someone else’s savings? With an increasing money supply, yes. Even if all savings were in the form of cash, and could be qualified as “leakages” from the economy, new money would still be entering the system (without causing inflation in the process).

And if you need any more evidence on how shaky the foundations of the Philips Curve are, seven Nobel prizes have been awarded for critical analysis of the Curve since 1974.  

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“The Blessings of Destruction”

Could destruction be good for the economy? Keynes certainly thought so. As he wrote “Pyramid-building, earthquakes, even wars may serve to increase wealth, if the education of our statesmen on the principles of the classical economics stands in the way of anything better.”

It would be nice to think that this is one Keynesian idea that even modern Keynesians would reject, but such is not the case. Appearing CNN’s Fareed Zakaria GPS in 2011, Krugman argued that had we learned of a coming alien invasion which prompted a massive military buildup for us to combat, the economic slump we were in would be over in six months. Though for whatever reason, while seeing benefits in destruction, Keynes himself warned against using government spending to cause “war and destruction,” so Keynes himself would be against what is known as “militarized Keynesianism.”

This sort of thinking isn’t original to Keynes. It was over a half-century before Keynes published his General Theory that Frederic Bastiat famously coined this mode of thinking “the broken window fallacy.” Bastiat illustrates the fallaciousness of this sort of thinking as follows. Suppose a shopkeeper named John is working while his son breaks a square of glass in the store. John is reasonably angry

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402 Fareed Zakaria GPS, Aired August 14th 2011 on CNN.
404 This essay is also known for establishing the concept of “opportunity cost.”
over this, but then what happens? James has to pay a glazier six francs to repair the damage. The glazier then spends those six francs on something else, and money continues circulating.

This is what Bastiat calls “the seen.” But as Bastiat’s famous essay is titled, there is “That Which is Seen, and That Which is Not Seen.” What would’ve happened if that window was not broken and the glazier was not paid? John would’ve spent those six francs on something else, which would’ve also had the effect of circulating money – and society would be one window better off in the process.

Another way to think of this fallacy is to think of the collective wealth of a society. Let’s say all the infrastructure, homes, etc. in a country are valued at $10 million, and are completely destroyed in a natural disaster. Certainly employing people to repair all the damage done would boost GDP, income, and employment. Let’s say that after a year’s time of working, the town is restored to its status before the disaster. Despite the positive effects this may have had on the economic statistical measurements listed, the collective wealth of that country still stands at $10 million. In the absence of a natural disaster, perhaps those workers wouldn’t have had as much work provided. Let’s suppose there was only half as many homes, roads, and bridges to build. Even though this wouldn’t boost GDP as much as the prior situation, the collective wealth of society would be $15 million in that case – much higher than the first example.

Hypotheticals aside, natural disasters do seem to boost GDP in the short run. Krugman points to Japan’s superior growth in the first quarter of 2012 relative to other advanced nations, due to their increased spending on
reconstruction following the then-recent tsunami.\textsuperscript{406} But while GDP did increase as a result of this natural disaster in the short run, catastrophe is a poor economic program.

The NBER has examined the effect of cyclone strikes from 1950-2008 on long run economic growth in the countries they devastated. As the data shows, the worse the disaster, the worse long run growth suffers, as “fifteen years after a strike, GDP is 0.38 percentage points lower for every additional 1 m/s of wind speed.” And that’s just GDP, a disaster in the 90\textsuperscript{th} percentile reduces income by 7.4\% two decades after.\textsuperscript{407} This led the authors to reject the “creative destruction hypothesis” in regards to natural disasters,\textsuperscript{408} which they define as the theory that “disasters may temporarily stimulate economies to grow faster because demand for goods and services increase as populations replace lost capital, because inflowing international aid and attention following disaster may promote growth, or because environmental disruption stimulates innovation.”\textsuperscript{409}


\textsuperscript{408} This is a different usage of the term “creative destruction” than what Austrian economist Joseph Schumpeter coined. Schumpeter, and many other economists use the term to refer to creative destruction in an industry, such as Polaroid’s downfall (destruction) as a result of the rise of digital technology (creation). In this context, natural disasters are truly destruction without creation.

\textsuperscript{409} “The Causal Effect of Environmental Catastrophe on Long-Run Economic Growth”
As Steve Horwitz once put it, “creating jobs is easy – it’s creating wealth that’s the hard part.”
Economic Myths

Corey Iacono, Matt Palumbo, and Kevin Ryan

Corey and I (Matt) have, for the most part, gained most of our following online from those who enjoy our economic myth busting. The two of us decided that this chapter would be our longest for this reason, and would be a joint-chapter. We also collaborated with Kevin Ryan for this chapter, who runs the phenomenal blog “Unbiased America.”

Gender Wage Gaps

The alleged male/female wage gap is an oft-cited statistic among those who learned economics in sociology class. When the statistic is cited, it’s framed as “for every dollar a man earns, a woman earns 80 cents.” Calculating the statistic is surprisingly unsophisticated. Full time average female earnings for a given year are divided into average full time male earnings for the year – and that’s all there is to the statistic.

The seldom-heard good news is that as of 2010, the gap has been at its lowest point on record, women earning 82.8 cents for every dollar of income men make. But this number is still understated, as many variables are responsible for the gap in male and female pay, such as the

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410 The majority of the content on the wage gap is taken from pp. 203-208 of my book “The Conscience of a Young Conservative.”
amount of hours spent working, career choices, dangerousness of work, and others.

**Hours**

The amount of hours worked by men and women is one of the greatest sources of our gap. Even though the statistic is calculated by looking at men and women who work full time, this still doesn’t mean they work equal hours, as “full time” is a term generally defined by the employer (but is usually 35+ hours a week). Men who work full time work an average 8.14 hours on a workday, while a woman working full time work 7.75 hours.\(^\text{412}\) That time difference alone explains a quarter of the wage gap.\(^\text{413}\)

**Gender Differences**

The second source of our gap is due to gender roles. Men don’t go through the process of giving child birth, and it’s generally the woman who takes off from work to raise the child. Although more women are entering the workforce, the duty of taking care of children is still done predominantly by women. The old saying for athletes is to ‘use it or lose it,” and the same law applies to other careers. When people take time off, they lose skills that they would’ve otherwise built up during that time. As the former feminist Warren Farrell calculated, “women who have never been married and are without children earn 117% as much as their male counterparts.”\(^\text{414}\)


\(^{413}\) Ibid.

The majority of women are not unmarried and without children for their entire lives however. A decade after graduating from college, 39% of women are out of the workforce, while only 3% of men are. A reverse effect occurs when men and women get married. While married men work more than unmarried men, married men with children work even longer because they have more people to take care of, married women work less than unmarried women.415

A paper prepared for and presented to the Department of Labor concluded that:

…the differences in the compensation of men and women are the result of a multitude of factors and that the raw wage gap should not be used as the basis to justify corrective action. Indeed, there may be nothing to correct. The differences in raw wages may be almost entirely the result of the individual choices being made by both male and female workers.416

Risk

The third source of the income gap comes from variables within an occupation that would alter income. Dangerous jobs pay far more than the average job does, and the top ten most dangerous jobs are dominated by males. The worker fatality rate for men is 5.5 deaths per 100,000, and

only 0.6 for women. The leading cause of death for women in the workforce isn’t a result of dangerous working conditions however – its homicide (which, as unfortunate as it is, isn’t a wage increasing variable).

It should be emphasized however that this only accounts for a small portion of the wage differential (roughly $432 of it).

**Choice of Major and Career**

A larger portion of men than women are employed in higher-paying fields. Only seven percent of women are employed in high paying computer and engineering fields, while thirty-eight percent of male professionals are. Some may object that men are predominant in these fields because women were discriminated against, but someone has yet to claim that men are discriminated against for being

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underrepresented in low paying fields such as elementary education. The basic fact that men and women have different career interests best explains this divergence. Computer Science classes in high school “International Baccalaureate” programs are dominated by men, while English classes have a female majority.

Regardless, one of the best ways to test for discrimination is to compare the kinds of majors men and women chose, and how it would help them get into one of these high paying fields.
# Most Common Bachelor’s Degrees for Men and Women 2008-2009

<table>
<thead>
<tr>
<th>Top Men Majors</th>
<th># of Degrees in Major</th>
<th>Median Mid-Career Salary</th>
<th>Top Female Majors</th>
<th># of Degrees in Major</th>
<th>Median Mid-Career Salary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business Administration and Management</td>
<td>66,190</td>
<td>$72,100</td>
<td>Psychology</td>
<td>68,808</td>
<td>$60,400</td>
</tr>
<tr>
<td>Finance</td>
<td>22,931</td>
<td>$88,300</td>
<td>Business Administration and Management</td>
<td>64,122</td>
<td>$72,100</td>
</tr>
<tr>
<td>Biology</td>
<td>21,906</td>
<td>$64,800</td>
<td>Nursing</td>
<td>61,405</td>
<td>$67,000</td>
</tr>
<tr>
<td>Political Science</td>
<td>20,947</td>
<td>$78,200</td>
<td>Elementary Education and Teaching</td>
<td>36,358</td>
<td>$52,000</td>
</tr>
<tr>
<td>Accounting</td>
<td>20,446</td>
<td>$77,100</td>
<td>Biology</td>
<td>33,950</td>
<td>$64,800</td>
</tr>
<tr>
<td>Psychology</td>
<td>20,432</td>
<td>$60,400</td>
<td>English Literature</td>
<td>28,945</td>
<td>$64,700</td>
</tr>
<tr>
<td>History</td>
<td>20,088</td>
<td>$71,000</td>
<td>Accounting</td>
<td>24,068</td>
<td>$77,100</td>
</tr>
<tr>
<td>Economics</td>
<td>17,756</td>
<td>$98,600</td>
<td>Communicatio n Studies</td>
<td>22,000</td>
<td>$70,000</td>
</tr>
<tr>
<td>Mechanical Engineering</td>
<td>15,424</td>
<td>$93,600</td>
<td>Sociology</td>
<td>20,064</td>
<td>$58,200</td>
</tr>
<tr>
<td>Marketing</td>
<td>14,613</td>
<td>$79,600</td>
<td>Liberal Arts</td>
<td>19,396</td>
<td>$63,200</td>
</tr>
<tr>
<td><strong>Average Median Salary:</strong></td>
<td><strong>$71,304</strong></td>
<td></td>
<td></td>
<td><strong>$64,601</strong></td>
<td></td>
</tr>
</tbody>
</table>

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When only the starting median salary is viewed, it’s 39,923 for men, and 39,478 for women – no real gap. When mid-career salary is looked at, there’s a $6,703 gap because majors that men chose have larger income growth over time. Even if career choice was the only factor in the wage gap, this accounts for 9.5% percentage points in the gap of men and women with college degrees. Of course, this data is raw, so mid-career salaries may be overestimated for women due to the variables causing the wage gap discussed (hours worked, child birth, etc.). For example – while the average business major makes $72,100 mid-career, women are less likely to accept high level business positions for personal reasons such as raising children, or having more free time, not because of discrimination.

Enforcing the same point above, women tend to choose majors which require less cognitive ability. Of all majors, less than 30% of Industrial Engineering majors (average IQ: 123) are women. The same holds true for Civil Engineering (124), Economics (128), Physics & Astronomy (133), Computer Science (124), and other forms of engineering. But 89% of those majoring in Social Work (Average IQ: 103) are women, and the figures are 77% for psychology (113), 69% for sociology (114), and 79% for education (110). None of this is to imply that women are less intelligent than men, as average male and female IQ’s are identical (though male IQ’s have a wider range).422

There are other gaps that cannot logically be explained away by discrimination. Women owned

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businesses tend to make significantly less money than male run businesses. Unless a female employer is discriminating against herself, other factors have to be explored. Among the results from a Rochester Institute of Technology study were that money motives 76% of men, but only 29% of women. Women employers also tend to have shorter workweeks, and desire more flexibility. Since most women owned small business owners don’t fit the “never married and never had children” category, this should be expected. One study on women run small businesses in Australia even found that “flexibility and the ability to balance work with their relationships and family” was a motivating factor for starting a business.423

Ironically, while the male-female wage gap is used as a liberal talking point to justify legislation correcting it, the apparent gap has shrunk faster under Republican administrations. The annual wage growth of women relative to that of men’s during the presidencies of Reagan and both Bush’s greatly outpaced that of both Clinton and Carter. Reagan averaged 1.6% growth, while Clinton averaged 0.21%.424

Other Obscure Sources

While no one has cited this before as a variable in the male-female wage gap, height may play something of a role. In a paper published at Harvard, Gregory Mankiw calculated the mean wage of the tall at $17.28 an hour, which is 16% higher than $14.84 an hour that the short earn. The study

defined “short” as those with heights of under 70 inches, and tall as a height of over 72 inches (6 feet). In the 30-39 age group, 11.5% of men are taller than 6 feet, while only 0.6% of women are.

A study published by economists at Princeton University argues that intelligence is the underlying cause of this gap, noting that “taller children perform significantly better on cognitive tests.” Another explanation for the pay differential is that those who grow up taller than average have more self-esteem growing up, which translates to success later in life.

The CEO/Worker Pay Gap

The gap between CEO and worker pay became highlighted as a problem in the mainstream as the Occupy Wall Street movement took off in 2011. In his book “The Conscience of a Liberal,” Paul Krugman writes that “CEOs have seen their income rise about thirty times that of the average worker in 1970 to more than three hundred times as much today.” Al Jazeera reports that “in 2013 the average

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American CEO was paid 331 times what the average worker in the United States earned and 774 times what full-time minimum wage workers made, according to a new analysis released Tuesday by the AFL-CIO, the nation’s largest labor union.\(^\text{430}\)

In an article on the website for Stanford University’s graduate school of management regarding CEO myths, the first myth tackled was “The ratio of CEO pay to that of the average worker is a useful statistic.”\(^\text{431}\) They say the statistic is meaningless because there are certain companies that require exorbitantly high CEO pay, but I would say the statistic is meaningless because it fails to do one thing: actually measure average CEO pay.

In my own experience, while sifting through liberal websites reporting on the AFL-CIO statistic (cited by Al Jazeera) nearly every single one claimed that the report measured average CEO pay, while what the report actually did was measure CEO pay at the nation’s largest 350 companies. Bulleted below are some other estimates of average CEO pay nationwide, when all CEOs are measured.

- The Bureau of Labor Statistics places the mean annual Chief Executive wage at $178,400, and the


median at $171,610. Both estimates exclude benefits.\textsuperscript{432}

- Forbes states that 2\% of CEOs in America have an annual salary above $3 million (excluding benefits), while 77\% earn $500,000 or less.\textsuperscript{433}

- A table in a study published in the Oxford Review of Economic Policy shows that in 2002, while CEO compensation averaged $10.3 million in S&P500 companies, it falls to $4.7 million in Mid-Cap 400 companies, and to $2.2 million in Small-Cap 600 companies. Companies in the “Mid-Cap 400” category have market capitalizations from $1.2 billion to $5.1 billion, while small-cap 600 companies have market caps of $350 million to $1.6 billion.\textsuperscript{434} This confirms that high CEO compensation is concentrated among the nation’s largest firms, and falls drastically when we look at smaller firms.

- Salary.com estimates median CEO compensation (salary + benefits + bonus) at $1,335,148. Without

benefits of bonus, median CEO pay is estimated at $738,533.  

**Why is the Gap Rising Anyway?**

While the actual gap between average CEO pay and average worker pay is miniscule, it is true that there is a rising CEO to worker pay gap among the nation’s largest companies. Answering the question of why the gap is rising will differ depending on what ideology someone belongs to. The explanation from the left seems to be that rising CEO pay reflects the rise in inequality in general, as those at the top take more and more for themselves, leaving less for everyone else.

Behavioral economists point to another cause: human nature. Duke University behavioral economist Dan Ariely hypothesizes in his book “Predictably Irrational” that the rise in the CEO/worker pay gap rose around the time that Federal regulations required companies to reveal the “pay and perks” of their top executives. Since news stations would run stories ranking CEOs by pay, this encouraged CEOs to pay themselves more and more to improve their ranks, as regulations established a sort of “high scores list” among CEOs.

As interesting as Ariely’s explanation is, there’s a simpler explanation: large companies have gotten larger. The National Bureau of Economic Research concludes that “the sixfold increase in CEO pay between 1980 and 2003

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can be fully attributed to the sixfold increase in market capitalization of large U.S. companies during that period.\textsuperscript{437}

Since the majority of a CEO’s compensation isn’t merely in the form of a salary and benefits, but stock in their company, we could expect to see a correlation between rises in top CEO pay and the stock market as a whole. See the two charts on the following page; the first on the CEO/worker pay gap, and the second of the stock market during the same time period. Note that both graphs follow the same trend.

Stock Market Value 1970-2014

Source: Yahoo Finance

It’s purely logical to assume that more money for a CEO means less money for other members of a company. And there really isn’t any way to argue against this basic fact, but it is easy to prove that there are few firms were CEO pay is so egregious that it has any substantial impact on workers earnings.

Let’s take McDonald’s as an example. According to the Christian Science Monitor in 2012, McDonald’s had the highest gap between CEO pay and worker pay in the nation (though some other sources grant JC Penny with this title), with CEO Donald Thompson earning 1,196 times what the average worker earns. Thompson earns $9,247 an hour — compared to $7.73 for the average McDonald’s employee.
In 2012, Thompson was compensated $13.8 million for his role as CEO.\textsuperscript{438}

So is it fair that Thompson earns in a single year that a McDonald’s employee would have to work nearly 900 years to earn? The answer certainly would be yes if Thompson could simply solve this problem by paying himself less, but that wouldn’t do much. McDonalds employs roughly 440,000 people (full time + part time).\textsuperscript{439} Even if Thompson decided to work pro bono and distribute his annual compensation among his workers, this would only translate to a $31.36 a year bonus per employee if distributed evenly – or less than a 1 cent an hour raise per employee.

That doesn’t seem like much – but Bloomberg reported that in 2011 JCPenny actually has the largest CEO to worker pay gap with a 1,795:1 ratio.\textsuperscript{440} Then CEO Ron Johnson earned a compensation package of $53.3 million,\textsuperscript{441} while JCPenny employed roughly 159,000 people.\textsuperscript{442}

\textsuperscript{442} Bhasin, Kim. "JCPenney's 43,000 Job Cuts Were Twice The Amount That CEO Ron Johnson Stated Read More: Http://www.businessinsider.com/jcpenney-cut-43000-jobs-2013-
Dividing up his salary between the number of workers would give each worker a $335.22 a year raise – but this would be short lived as Johnson’s compensation fell 97% to $1.9 million the next year.\(^{443}\)

**Random CEO Pay Myths – Pay and Performance**

There are dozens of studies “proving” and “disproving” whether or not CEOs are paid for performance. One failure of studies into CEO pay and performance is the inability to account for the effects of a turnaround CEO. A turnaround CEO will receive his hefty salary, while the company he’s restructuring may turn losses for the first few years of his tenure, even if the company then enjoys large profits in the long run because of that CEOs work. Many studies “disproving” the claim that CEOs are paid for performance suffer from this problem. There is a growing trend for pay to be linked to performance. A survey of fifty one CEOs of large companies showed that over half had their pay linked to their performance, up from 35% in 2009.\(^{444}\) And obviously, since CEOs receive a large percentage of their compensation in the form of stock, a better performing company will translate to the stocks they receive being of a higher value.

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Henry Ford

It may seem like an odd source for economic myths, but the history of the Ford Motor Company is the source of various historical and economic myths with serious implications if they were to be true. The first, and biggest myth is that Henry Ford paid his workers well (the unheard of $5 a day wage) – and succeeded because they were “paid enough to purchase the product.” This myth has been around for so long that even Henry Hazlitt devotes an entire chapter to it in his 1946 book “Economics in One Lesson.”

As one writer circulates the myth in The Daily Beast:

So this was Ford’s theory: Companies had an interest in ensuring that their employees could afford the products they produced. Put another way, employers had a role to play in boosting consumption. While paying higher wages than you absolutely needed to might lower profits temporarily, it would lead to a more sustainable business and economy over time. If the motorcar was going to be a mass-produced product for typical Americans, not a plaything for the rich, Ford would strive to pay his workers enough so they could afford the products they worked on all day.

Of course, anyone who understands the concept of return on investment (ROI) may read the above statement and have something of a feeling that something isn’t quite right. Let’s think about it: let’s say I’m selling a car for $300, and I pay my worker $5 a day. Assuming that worker saves all his income, he can afford to purchase my product after 60 days. Even if that car cost absolutely nothing to produce, all that

445 Hazlitt, Economics in One Lesson, pp. 133-139
happened is $300 in wages circulating out, and back into the company – a ROI of 0.

All “paying to buy the product” does is allow businesses to retain revenues. Anyway, the same liberals who make this argument also criticize companies like Walmart for paying workers so little that they can only afford to purchase Walmart products – as if there’s any real difference in either case. And just a side note, Ford’s $5 a day wage today would be worth around $14.88 an hour today,\textsuperscript{446} while the average Walmart employee earns $12.88 an hour\textsuperscript{447} (granted, Ford’s $5 a day wage was notably higher in proportion to median income at the time).

Hazlitt’s rebuttal focused on another logical flaw with the argument: that it would be impossible for every industry to pay their workers enough to purchase their own product. Since this argument is used to justify high wages, Hazlitt notes that it’s proponents “surely cannot mean that makers of cheap dresses should have enough to buy back cheap dresses, and the makers of mink coats to buy back mink coats.”\textsuperscript{448} And this argument works for companies selling products to the higher end of the income distribution. Does anyone in their right mind think Rolls Royce could afford to pay all their employees enough to purchase one of their vehicles?

\textsuperscript{446} Using the CPI, $5 a day in 1914 would be worth $118.95 in 2014 dollars. The $14.88 figure assumes an eight hour work day.


\textsuperscript{448} Hazlitt, Economics in One Lesson, p.134.
So if not for workers to buy back the product, why? The answer is simple: turnover. The year before Ford introduced his revolutionary $5 a day wage, he faced a turnover rate of 370%. To put that in context, Walmart today has a turnover rate of 100%. Ford’s wage is what economists call an efficiency wage, which is a wage not set by market equilibrium (whereas the price of labor is set by the supply and demand for labor) but other factors, mainly a desire to improve efficiency or reduce worker turnover. And it worked – the day after Ford announced he was raising wages to $5 a day, 10,000 people came to Ford looking for work, and by the next year turnover dropped to 16%.

This sort of argument also translates over to the minimum wage debate, whereas proponents of the minimum wage will argue that a higher minimum wage will reduce worker turnover and improve their productivity. However, it’s not high wages that reduce turnover – it’s high wages relative to wages paid by similar firms in an industry (a point made even by Paul Krugman in the minimum wage debate). As for higher wages increasing productivity,


451 Krugman writes: The obvious economist's reply is, if paying higher wages is such a good idea, why aren't companies doing it voluntarily? But in any case there is a fundamental flaw in the argument: Surely the benefits of low turnover and high morale in your work force come not from paying a high wage, but from paying a high wage “compared with other companies” -- and that is precisely what mandating an increase in the minimum wage for all companies cannot accomplish. Krugman, Paul. "The Living Wage." Paul Krugman Archive, Sept. 1998. Web. <http://www.pkarchive.org/cranks/LivingWage.html>.
studies purporting to show this link suffer from reverse causality, that more productive workers see higher wages.\textsuperscript{452} Technically one way that the minimum wage could boost productivity is if the wage required firms to downsize their workforce and instead increase the workload on their existing employees, but it’s unknown how many firms are in the position of being able to have that possibility be practical.

\textbf{Socialized Internet}

Is providing the internet one thing the government does better than the private sector?

Progressive radio host Thom Hartmann writes that “For less than $70 per month, residents browse the World Wide Web on a high-speed fiber-optic connection that shoots data back and forth at one gigabit per second,” and that “one gigabit-per-second is 50 times faster than the average internet speed for homes in the rest of the US, and is just as fast as internet service in Hong Kong, which has the fastest internet on the planet.”\textsuperscript{453}

Hartmann mentions that Chattanooga received $111 million in stimulus funding for this project, but the total cost came with a price tag of $330 million, nearly triple of what Hartmann claimed it was. Chattanooga has a population of around 171,000, but only 3600 residents are able to get 1Gbit


speed\textsuperscript{454} - which is a cost of $92,000 per person for those who actually get “50 times faster speed than the rest of the country.”

With that price tag considered, dialup might be preferable.

**The Myth of Low Taxes**

After the issue of the budget became an issue again following the rise of the Tea Party, the talking point that taxes were at “sixty year lows” was spawned. As the former conservative Bruce Bartlett wrote in his column at the New York Times, “the Congressional Budget office estimated that federal taxes would consume just 14.8\% of G.D.P. this year. The last year in which revenues were lower was 1950.”\textsuperscript{455}

Since Bartlett’s Master’s degree is in American history (from Georgetown University nonetheless), he’s certainly familiar with the fact that the American system of government doesn’t collect taxes on just the Federal level – it collects taxes on the Federal, State, and Local level.

While taxes at the Federal level have been relatively stable over recent decades (before falling in the most recent recession), taxes at all levels of government have not. Tax revenues at all levels of government amounted to 22.7\% of


GDP in 1950, but 32.4% of GDP in 2011 – a 42% increase.456

The Myth of Small Government

Taxes aren’t low, but what about the size of government? A piece by Catherine Rampell from 2012 in the New York Times made two claims: that government is shrinking and is small by historical standards.457

Amusing is how she measures the recent shrinkage in government and historical size by contradictory measurements. She measures the recent decline in government size by showing a decline in the number of people employed at the Federal, State, and Local levels of government. When she looks at the historical size of government, she singles out the Federal government’s size as the percentage of the economy.

The first measurement brings an interesting question to mind. Which government in this scenario is bigger: one which spends $1 million to employ two people, or one which spends $2 million to employ one person. By Rampell’s measurements, the first government would be defined as bigger, even though the seconds takes up more resources to fund. By Rampell’s own measurements, she emphasizes how declines in state and local government are responsible for most of the recent decline in government size, which gives her no excuse not to include state and local government

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when she’s making the claim that the size of government is at a historic low.

The size of Government at all levels has hovered at around 35% of GDP since the 1980s. Rampell picks 1947 as her starting point when she argues that the Federal government’s expenditures has averaged 20.2% of GDP since then. But when we measure total government expenditures, they amounted to 23.1% of GDP in 1947, and 37.86% of GDP in 2012458 (the year Rampell published her column).

**Fiat Currency and Wages**

The myth discussed here is almost like the libertarian version of the “wages have trailed productivity” myth. The argument goes like this: in 1964, the minimum wage was $1.25. Quarters were made of silver at that time – and today, the melt value of those quarters would be above $26.459 The implications from this claim are supposed to be that while people debate the merits of the minimum wage, they should really focus on monetary policy if they care about workers’ wages.

The supply of commodities like gold and silver is fixed, so we shouldn’t be surprised when we see their value appreciate over time. Workers’ wages are, for the most part, determined by their productivity.460 Let’s say for instance, a

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460 As is the case with every issue, there are exceptions. If, for example, demand for a certain profession increased while the supply of laborers in that profession remained constant, increases in wages offered by
worker’s productivity allowed him to produce $1.25 in 1964, and he was paid exactly that - $1.25 in silver quarters. What happens if the value of those five silver quarters rises to $2.00 while productivity remains at $1.25? The worker’s pay doesn’t magically rise to $2.00 an hour while his employer ignores the $0.75 loss he endures. Instead, wages would adjust downward. The worker may temporarily benefit in the brief period between the value of silver increasing and his wages adjusting back to their previous level, but that would be the only benefit.

If we really care about workers’ wages, paying them in silver may be a bit cheap. In 1986, the minimum wage was $3.35, which could’ve purchased 37 shares in Microsoft at that time. By June of 2014, those 37 shares would be worth $1563.25.

Middle Class Myths

The fact that the middle class is shrinking is almost taken as conventional wisdom. Pundits left and right from Ed Schultz to Lou Dobbs decry that there exists a war on the middle class. And even experts echo this line of thinking. Nobel Prize winning economist Joe Stiglitz declared in a speech before the AFL-CIO, “we use to pride ourselves--we were the country in which everyone was middle class. Now that middle class is shrinking and suffering.”

The impression we’re supposed to have is that the middle class is shrinking because we’re becoming poorer as employers would increase at a faster pace than productivity gains in that industry to attract more workers.

461 Value was 0.09 per share in March of 1986, and 42.25 in June of 2014.
462 Joseph Stiglitz's remarks to the AFL-CIO convention in Los Angeles on September 8.
a nation – but that isn’t the only reason a middle class can shrink. If middle class is defined as a fixed point of income, the middle class can decline from those previously deemed middle class becoming poorer – or richer. While those who see the middle class shrinking are indeed observing something that is occurring, they’re focusing their attention in the wrong direction. As charted below, those with middle and lower levels of income are declining, but because a growing percentage of people are earning higher levels of income.

![Percent Distribution of US Families by Income Level in Constant 2009 Dollars, 1967 to 2009](chart.png)

Source: American Enterprise Institute

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463 Perry, Mark J. "Yes, the Middle Class Has Been Disappearing, but They Haven’t Fallen into the Lower Class, They’ve Risen into the Upper Class." American Enterprise Institute, 12 July 2012. Web. <http://www.aei-ideas.org/2013/07/yes-the-middle-class-has-been-disappearing-but-they-havent-fallen-into-the-lower-class-theyve-risen-into-the-upper-class/>. 
In light of this information, it makes more sense to track what percentage of households are middle class or higher, rather than simply middle class. That’s a figure which has remained largely unchanged historically, from 76% of households in 1970, and 75% in 2010.\textsuperscript{464} Keep in mind that 75% of households had that status in 2010 despite a recent economic downturn.

But what about current hardships of the middle class? Listen to the narrative of Elizabeth Warren in her book “The Two Income Trap,” or Robert Reich’s “Inequality for All” and we’re told that the middle classes expenses have risen considerably. Take housing for instance, which Warren cites as having increased 76% between 1970 and 2004.\textsuperscript{465} Overlooked by Warren is two data points: the average square footage of housing increasing from 1400 square feet to 2330 in her time frame, and the fact that home prices in 2004 were the near peak of the housing bubble.

With home size and inflation adjusted for, there was a 40% increase in real housing price per square foot from 1970-2004.\textsuperscript{466} But if we go back to 2000, there was only a 19% increase in the price of housing per square foot since 1970. If we look at 1996 prices, we see only a 3.7% increase in the price of housing per square foot since 1970. Once

\begin{itemize}
\item \textsuperscript{465} Warren, Elizabeth. “The Coming Collapse of the Middle Class. Presented at UC Berkeley on June 11\textsuperscript{th} 2007. This talk is a presentation of her book “The Two Income Trap.”
\item \textsuperscript{466} A spreadsheet sourcing inflation adjusted home prices from 1970-2011 is available at: <http://www.jparsons.net/housingbubble/>. After adjusting for inflation and household size, real home prices averaged $145,983 in 1970, and $242,975 in 2004.
\end{itemize}
again, this isn't to say that a home in 1996 only cost 3.7% more than a home in 1970, but that a home cost only 3.7% more in 1996 after you adjust for increases in inflation and home size. Thus, nearly the entire increase can be explained away by people buyer bigger homes, and the housing bubble.467

What about something like healthcare, which no one can ignore has far outplaced increases in inflation? Healthcare costs have indeed exploded since the 70s, but healthcare costs as a percentage of a middle class family’s income has remained stagnant, since increased benefits have been a growing share of the typical person’s income.468

If you want to know what’s really taking a bite at the middle class, blame taxation. Warren claims that the typical middle class family pays 25% more in taxes than in 1970 – but the real number is 140%.469

Costco Vs. Walmart: How One Savvy CEO Played Into Our Policy Biases470

The Interview

In July, 2005, James D. Sinegal, co-founder and then-CEO of warehouse retailer Costco, sat down for an

467 It should be noted that there have been quality improvements to homes as well, which means that some of the increase in price reflects an increase of quality. In 1975, 46% of new homes had central air conditioning, while in 2002 87% did.
470 Addition by Kevin Ryan
interview with Steven Greenhouse of the New York Times. After the obligatory tour of one of the company’s massive stores and sampling of some of its steeply discounted products, the discussion turned to Costco’s business model.

“How [is it] better to be an employee or a customer than a shareholder” at Costco, Greenhouse asked, referencing criticism from analysts that the company paid too much to its workers and too little to its owners. Paying higher wages is good business, Sinegal answered. “This is not altruistic.” He added that good wages and benefits are why Costco has extremely low rates of turnover by employees.

What Sinegal (and the media) began shaping that day was a narrative that has made the company a darling of the left. “He rejects Wall Street’s assumption that to succeed in discount retailing, companies must pay poorly and skimp on benefits,” Greenhouse wrote in a long New York Times puff piece that Sunday. “Costco’s average pay, for example, is $17 an hour, 42 percent higher than its fiercest rival, Sam’s Club. And Costco’s health plan makes those at many other retailers look Scroogish.”

The article also took a jab at Wall Street, creating a lot of Costco fans among the nascent Occupy movement that day. “Emme Kozloff, an analyst at Sanford C. Bernstein & Company, faulted Mr. Sinegal as being too generous to employees... ‘He has been too benevolent,’ she said. ‘He’s right that a happy employee is a productive long-term employee, but he could force employees to pick up a little more of the burden.’... Sinegal has largely shunned Wall Street pressure to be less generous to his workers.”

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Reaction to the Times article was overwhelmingly positive, especially within the progressive community. “There can be no doubt - Mr. Sinegal is truly a great man who understands that good business means treating your workers well,” wrote The Northwest Progressive Institute.472

Liberal forums like Democratic Underground lit up with comments glorifying Sinegal and Costco.473 Online media474 and bloggers followed suit.475 The mainstream media ate it up, with ABC giving a lengthy tribute on 20/20.476

The anti-Walmart angle added a corporate villain to the narrative, and what had been praise for Costco turned into fawning worship. Here was the savior to all our problems, at once giving employees a living wage and


freeing them from the evil Walmart and a business model that thrived off of slave wages.

The narrative went viral, and has maintained its place in liberal circles ever since. Daily Kos, AddictingInfo, and Being Liberal routinely plaster pro-Costco and anti-Walmart content on their pages.

But is Costco’s business model really a better alternative for Walmart’s employees? Or just a brilliant marketing strategy?

The Tale of the Tape

The first problem with this narrative is that Costco and Walmart are completely different types of stores. Costco is a warehouse retailer, while Walmart is a traditional discount retailer. They have different product variety, different competitors, and target different customer segments.

History

Walmart began in 1945 when Sam Walton opened a franchise Ben Franklin variety store in Newport, Arkansas. In 1962 the first Walmart Discount City opened in Rogers, Arkansas. In 1984, the first of the company’s Sam’s Clubs warehouse stores opened. In 1988, the first supercenter

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Costco was founded by Jim Sinegal and Jeffrey Brotman in Seattle in 1983, Sinegal having previously worked for Price Club, the original warehouse club. Ten years later, Costco merged with Price Club, and in 1997 all Price Club locations were rebranded Costco. To this day the company has stuck to the warehouse format, rather than diversifying as Walmart has.

**Locations**

Walmart has a staggering 11,000 stores worldwide, more than half of which are locate outside the United States. Domestically, they operate in all 50 States, Washington D.C., and Puerto Rico.
Costco is tiny by comparison, with only about 650 stores, or less than 6% as many as Walmart. Nearly three quarters of its stores are in the U.S.\textsuperscript{481}

### Stores

Costco warehouse clubs are considerably larger than the average Walmart store, though Walmart’s Supercenters are larger still. Costco has only one format, while Walmart has several, including new small neighborhood stores averaging just 40,000 square feet.

The most direct competitor to Costco in Walmart’s stable is the Sam’s Club chain of warehouse clubs. Similar in size and

\begin{table}
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\begin{tabular}{|c|c|c|}
\hline
\textbf{TOTAL RETAIL LOCATIONS} & \textbf{10,941} & \textbf{649} \\
\hline
Supercenters & 3,288 & 0 \\
Discount Stores & 508 & 0 \\
Small Formats & 406 & 0 \\
Warehouse Clubs & 632 & 461 \\
International Clubs & 25 & 188 \\
International Stores & 6,082 & 0 \\
\hline
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\begin{tabular}{|c|c|c|}
\hline
\textbf{AVERAGE SQUARE FOOTAGE} & \textbf{100,693} & \textbf{140,000} \\
\hline
Supercenter & 179,397 & 140,000 \\
Discount Store & 105,307 & \\
Small Format & 38,767 & \\
Warehouse Club & 133,516 & 140,000 \\
International Club & 133,516 & 140,000 \\
International Store & 58,655 & \\
\hline
\end{tabular}
\end{table}

function to Costco, Sam’s Club locations actually outnumber Costcos by 657 to 649. However, they represent only 6% of all Walmart’s properties.

**Finances**

Walmart is a behemoth. Annual sales of nearly half a trillion dollars make it the largest public corporation in the world.\(^{482}\) It is also the biggest private employer in the world with 2.2 million employees, the largest retailer in the world, and the largest seller of groceries in America. Costco is considerably smaller, with sales of about $100 billion.

Walmart has higher operating expenses. It paid out 22% of its revenue to operating expenses, employees, and taxes, versus 11% paid out by Costco. Costco, on the other hand, spent more of its revenues purchasing inventory from suppliers and manufacturers, with cost of goods sold totaling 87% of revenues versus 75% for Walmart. In other words, Walmart saves money by paying less to its suppliers than

<table>
<thead>
<tr>
<th>PRODUCT MIX</th>
<th>FYE 1/31/14</th>
<th>FYE 9/1/13</th>
</tr>
</thead>
<tbody>
<tr>
<td>Groceries and Sundries</td>
<td>56%</td>
<td>56%</td>
</tr>
<tr>
<td>Softlines (Apparel, Media, Houseware)</td>
<td>25%</td>
<td>11%</td>
</tr>
<tr>
<td>Hardlines (Appliance, Hardware, Electronic)</td>
<td>9%</td>
<td>16%</td>
</tr>
<tr>
<td>Ancillary and Other (Pharmacy, Food Court, etc)</td>
<td>10%</td>
<td>17%</td>
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</tbody>
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Costco does, while Costco saves money by paying less in operating expenses and taxes.

<table>
<thead>
<tr>
<th>FINANCIALS</th>
<th>FYE 1/31/14</th>
<th>FYE 9/1/13</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$476.3 billion</td>
<td>$105.2 billion</td>
</tr>
<tr>
<td>Gross Income</td>
<td>$118.2 billion</td>
<td>$13.2 billion</td>
</tr>
<tr>
<td>Operating Income</td>
<td>$26.9 billion</td>
<td>$3.1 billion</td>
</tr>
<tr>
<td>Income Taxes</td>
<td>$8.1 billion</td>
<td>$1.0 billion</td>
</tr>
<tr>
<td>Net Income</td>
<td>$16.0 billion</td>
<td>$2.0 billion</td>
</tr>
<tr>
<td>Dividends</td>
<td>$6.1 billion</td>
<td>$3.6 billion</td>
</tr>
<tr>
<td>Total Assets</td>
<td>$204.8 billion</td>
<td>$30.3 billion</td>
</tr>
</tbody>
</table>

Costco’s financial statements reveal another blow to the narrative that it treats its workers better than its shareholders. At the end of 2012, congressional negotiations were being held to raise the tax rate on dividends. Costco decided to pay a huge, special cash dividend to its owners so they wouldn’t have to pay the higher taxes that were set to take effect January, 2013. The dividend payments totaled $3.6 billion, or $8.17 per share, more than four times the per share amount paid by Walmart that year. Indeed Costco could have given each and every employee a $20,000 bonus with that cash. Instead, the money went to investors and owners.

Product Mix

Both Walmart and Costco have a broad mix of product types, from food to furniture to electronics to pharmacy services. Costco does focus more on large appliances, electronics, automotive, and the like, while

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Walmart gets more of its revenues from smaller items like apparel, jewelry, movies, etc.

Product Variety

Perhaps the most important difference to understand when comparing Walmart to Costco is the product variety each store keeps on hand. Retailers measure product variety by the number of “stock keeping units”, or SKUs, they sell. Each SKU is a distinct product or service. For example, a particular brand and size of peanut butter would be represented by a unique SKU.

A typical Costco store has around 3,700 SKUs. The average Walmart has 140,000 SKUs. Costco keeps it’s products on pallets, restocked in bulk by forklifts. With such little variety, customers have an easier time finding their products, and need less help than in traditional discount stores.

Each of Walmart’s 140,000 SKUs have to be sorted, replaced on shelves, reordered, delivered, and so forth. That’s 35 times more products than a typical Costco. The amount of labor necessary to keep a Walmart in operation is huge.

Business Strategy

What underpins these differences are two very different business strategies that don’t target the same customers. According to Costco’s 10-K:

Our strategy is to provide our members with a broad range of high quality merchandise at prices consistently lower than they can obtain elsewhere. We seek to limit specific items in each product line
to fast-selling models, sizes, and colors. Therefore, we carry an average of approximately 3,700 active stock keeping units (SKUs) per warehouse in our core warehouse business, as opposed to a significantly higher number of SKUs at discount retailers, supermarkets, and supercenters. Many consumable products are offered for sale in case, carton, or multiple-pack quantities only.\footnote{Costco Wholesale Corporation. \textit{2013 10-K Report}. Costco Wholesale Corporation, 2013. Web. 22 August, 2014.}

By limiting each product line to fast-selling varieties, Costco reduces the amount of time products sit on the shelves taking up valuable store space. Also, selling in bulk effectively transfers inventory from the store to the customer. In return for buying greater-than-normal quantities, the customer receives a discount, and the store moves more product. Thus low margin is made up for by higher volume.

Costco additionally charges its customers an annual membership fee, which motivates repeat returns by people attempting to recoup the fee with more purchases of low price products.

But what type of customer does this attract? Well, for one thing, it’s more expensive to buy a six tube multipack of Crest toothpaste than to buy just one tube. So customers must have enough money to purchase in advance of their needs. Indeed the average Costco shopper visits the store just eleven times each year, stocking up for the month ahead.\footnote{Pride, William M., Robert James Hughes, and Jack R. Kapoor. \textit{Business}. 11th ed. Boston: Cengage Learning, 2011. 426. Print.}

Costco knows this means wealthier people shop there. So it caters to a more affluent crowd than most discount retailers. The median household income for a
Costco shopper is $71,000,$^{486}$ considerably higher than the overall median household income in the United States, which was $51,017 in 2012.$^{487}$

“We sell high-end items at a great value or at a great price,” says Jeff Elliott, assistant vice president, finance and investor relations for Costco.$^{488}$ But any more people can’t afford high-end products, and only have enough room in their budget to buy a few days of supplies at a time. For these people, the large packaging format and limited selection of higher-end Costco products are simply too expensive.

Instead, for them, Walmart is the ideal location to shop. According to Walmart’s 10-K, “We earn the trust of our customers every day by providing a broad assortment of quality merchandise and services at everyday low prices.”$^{489}$ The key to its marketing strategy is a broad range of low priced products, as opposed to Costco’s limited range of higher priced products. This attracts a very different sort of customer.

The average household income for a Walmart shopper is $45,000.$^{490}$ Walmart customers visit the store closer to once a week, far more than Costco’s once-a-month

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$^{486}$ Ibid.
customers. They spend from $50 to $60 dollars per trip, buying what they need for the week.

Indeed there are far, far more people who fit the description of a Walmart customer than that of a Costco customer. This is a key reason that it’s one of the most successful companies in history. Walmart serves more than 100 million customers in 26 countries... per week. The store is a key ingredient in the lives of lower income Americans. Food stamps are often used as a form of payment, something Costco didn’t even accept until 2009.

Wide product variety is an absolute must for the Walmart shopper, who looks to the retailer for all his or her shopping needs. This became apparent when the company cut its huge selection by a mere 8,500 SKUs in an effort to increase productivity, only to be berated by so many complaints that it was forced to bring them back. Walmart essentially has to be everything to everyone.

And that’s what makes it impossible for Costco’s low variety, high end business model to function at Walmart. It would make the store incompatible with the needs of lower income Americans, and depriving them of one of their most important means of making ends meet.

492 Ibid.
Employees

To most people, a cashier at Walmart looks a lot like a cashier at Costco. A young woman (72% are female), single mother perhaps, trying to scrape out a living. Why, then, should the Walmart cashier make 25% less than the Costco cashier? Don’t they both have the same bills to pay and the same mouths to feed? Many people label this a social injustice. The world’s largest corporation taking advantage of the weak.

Yet there’s a big difference between taking advantage of someone against their will and providing someone a job they take advantage of voluntarily. Indeed what’s lost in the hyperbole is the fact that more people choose to work at Walmart than at any other private sector corporation in the world.

And the reason many people chose to work at Walmart is because they have so few alternatives available to them at this point in their lives. Perhaps they couldn’t afford college. Maybe they were divorced by their spouse after years of raising kids and don’t have the experience to do anything else. Or they suddenly became widowed and found themselves without a source of income.

For these people, a job at Walmart is a godsend. Not only does it pay them, but it gives them training and experience with which to eventually pursue a better job. And the ubiquity of Walmart stores (90% of Americans live within 15 miles of one) makes it perhaps one of the most

important outlets for empowering low skilled labor left in America.

Costco, on the other hand, *doesn’t* hire these type of people, a fact its ideological supporters should consider before praising the company’s business plan. As Pat Callans, vice president of human resources at Costco points out, “the company gets tons of applications and can afford to hire selectively.”

In other words, they only hire the best and most experienced applicants. And that is why they pay more than Walmart, which hires far more employees, less selectively, and therefore at lower wages.

The question becomes, if Walmart switched to Costco’s business plan, and only hired educated, experienced workers, what would happen to the millions of less educated, inexperienced people who currently apply for jobs at Walmart?

Also, Costco’s business plan is based on reducing the amount of labor needed to succeed in retail. Automated

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checkout means fewer cashiers, and less variety means fewer products to sort, track, reorder, and restock. Indeed Costco hires half as many employees per square foot as Walmart does.\textsuperscript{499} Again, what would happen to those workers displaced if Walmart shifted to such a strategy?

**Minimum Wage Wars**

Costco recently made news by supporting an increase in the minimum wage to $10.10 an hour.\textsuperscript{500} The announcement was praised by those who see Costco’s worker-friendly actions as atypical in the business world. Walmart, after all, has not come out in support of raising the minimum wage. Isn’t this evidence that Costco is more socially responsible relative to other companies?

Perhaps. But you can be sure the company wouldn’t be taking such steps if it felt it’d be harming itself. In fact there’s often an ulterior motive behind seemingly altruistic moves, complete with legal and accounting teams explaining how the action would benefit shareholders.

And in the case of Costco’s call for a $10.10 minimum wage, the truth lay in the details. Costco already pays its employees over the proposed minimum wage level, so they would not be affected.\textsuperscript{501} But the labor-intensive budget retailers like Walmart, Target, and Kmart would see


their business model disrupted. Costco’s call for a $10.10 minimum wage may not be so benevolent after all.

In fact, in 2005, it was Walmart calling for the minimum wage to be increased, from $5.15 to $7.25, since at the time Walmart was already paying its sales associates from $8.23 (according to Business Week)\(^{502}\) to $9.68 (according to the New York Times)\(^{503}\). So, by supporting an increase in the minimum wage to $7.25, Walmart knew it would not affect its bottom line. However, any of its competitors who were paying less than $7.25 would get hurt by the increase. Walmart was hoping to squeeze its competition in 2005, just as Costco is doing today.

**Conclusion**

The corporate ‘heroes and villains’ narrative created by Costco executives and the media largely succeeds because of the public’s misunderstanding of how vastly different Walmart and Costco’s businesses are. But the narrative also feeds into an age-old political battle between the left and the right over the role of companies in promoting and following ‘socially responsible’ business practices.

Should Costco be giving its shareholders $3 billion in dividends the week before the tax rate on dividends increases? Doesn’t that cheat the public out of millions in tax dollars? And wouldn’t it be more socially responsible to pay that cash out to the workers who actually helped earn that money?


Why does Walmart receive hundreds of millions of dollars in government funded subsidies, free land, and tax abatements, while many of its workers slave away at minimum wage?\textsuperscript{504}

These are but a few legitimate questions often raised by critics of corporate business practices. Companies like Walmart are crucified in the court of public opinion for utilizing loopholes and freebies in their quest for profit. But what would happen if it didn’t take advantage of these laws?

Somebody else would.
Business is survival of the fittest. Only the companies that address the public’s needs by offering the best products at the best prices will prosper. The quest for the best price is what motivates companies to seek out every advantage they can find. If Costco decided not to partake in government subsidies, yet BJ’s did, then BJ’s would have lower costs, and be able to charge that much less for their products.

In the end, corporate responsibility means not only giving fair wages to your employees, but also fair prices to your community. Responsible companies will therefore include those with the most people willing to work there, and those with the most people willing to shop there. On top of both those lists is Walmart.

“Offshoring Is a Drag on American Wages and Employment”

Opponents of international free trade and economic globalization often claim that corporations are shipping jobs, which, in their view, rightfully belong to Americans, overseas. In reality however, research finds that greater employment by foreign subsidiaries of American companies

is not associated with reduced employment at home. Take for example, research conducted by economists from Harvard and the University of Michigan which examined American manufacturing firms over the time period 1982-2004. The authors examined how domestic employee compensation (wages and benefits) and investment changed in relation to changes in employee compensation and investment in their foreign subsidiaries (which were triggered by foreign economic growth). According to the economists:

Foreign investment that is triggered by foreign economic growth is associated with growing domestic capital accumulation, employment, compensation, R&D, and exports to related parties…10% greater foreign investment is associated with 2.6% greater domestic investment, and 10% greater foreign employee compensation is associated with 3.7% greater domestic employee compensation. These results do not support the popular notion that expansions abroad reduce a firm's domestic activity, instead suggesting the opposite.  

Thus, higher employee compensation and higher investment overseas is associated with higher domestic employee compensation and higher investment, albeit to a lesser degree. Moreover, a 2012 survey found that the average annual compensation paid in 2010 by American companies with foreign operations to their American workers was $70,700 compared with $52,900 for U.S. businesses without

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foreign operations.\textsuperscript{506} Additionally research finds that “an average of 134 U.S. jobs are created in a parent company’s U.S. operations for every 100 jobs added abroad in its foreign affiliates.”\textsuperscript{507}

Moreover, labor economists of the Centre of Economic Performance examined how both immigration and offshoring affected employment within the U.S manufacturing sector between the years 2000 and 2007. According to their research:

Despite the widely held belief that immigration and offshoring are reducing the job opportunities of U.S. natives, we have found instead that, during our period of observation, manufacturing industries with a larger increase in global exposure (through offshoring and immigration) fared better than those with lagging exposure in terms of native employment growth.\textsuperscript{508}

Lastly, according to the Organization for Economic-Cooperation and Development (OECD), the World Trade Organization, U.S International Trade Commission, and National Bureau of Economic Research respectively:

- “Studies for the United Kingdom, United States, Germany and Italy reach the conclusion that offshoring immediate goods has either no or positive effects on \textbf{both employment and wages}…A study of EU [European Union] countries, Switzerland, and


\textsuperscript{508} Ottaviano, Gianmarco et al: (2012). “Immigration, offshoring, and American jobs”. Centre for economic performance
the United States shows that off-shoring services also tends to complement local employment.”

- “Offshoring of activity may lead to higher job turnover in the short run…in the long run, there is no indication that trade or offshoring leads to higher unemployment (or lower employment) overall, although employment of low-skilled workers may suffer while high-skilled employment may expand.”

- “We find that foreign affiliate employment in high-income countries is complementary with U.S. parent employment (U.S. employment in manufacturing is higher when foreign affiliate employment in high-income countries is higher); foreign affiliate employment in low-income countries seems to have no effect on U.S. parent employment. This last point runs contrary to the claims of the opponents of offshoring that posit that jobs abroad replace jobs at home.”

- “The empirical evidence to date, while still tentative, actually suggests that increased employment in the overseas affiliates of U.S. multinationals is associated with more employment in the U.S. parent rather than less.”

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509 Ibid.
This evidence doesn’t exactly support the belief that offshoring leads to lower American wages or employment, in contrast, companies which are involved in overseas production pay their domestic employees better and hire more domestic workers as foreign compensation and employment rises. However, why is this the case? According to the authors of the aforementioned research by the Centre for Economic Performance:

Efficiency gains can be reaped by hiring them [immigrants or foreigners] to perform tasks in which, due to their skills, they have a relative advantage, giving native workers the opportunity to specialize in the tasks in which they exhibit their own relative advantage.513

In short, these efficiency gains are a result of differing comparative advantages between countries and individuals. Ultimately, this research seems to debunk the assertion that offshoring increases domestic unemployment. In contrast, there is rather convincing evidence that offshoring actually increases domestic employment and wages, or has no effect on them.

**Sweatshops and Child Labor**

Critics of free trade, economic globalization, and offshoring are almost always critics of sweatshop and child labor in developing countries. Moral outrage in response to media coverage of the abhorrent working conditions in third world countries is natural. However, most of the outrage against sweatshop and child labor is derived from people who have chosen not to ask themselves why third world residents choose to work in sweatshops or have their children work. Once this question is asked, the obvious answer is that third world peoples choose to work in

513 Ibid. #4
sweatshops, or have their children work, precisely because that is the best option available to them.

When multinational corporations are accused of “exploiting” third world workers by paying them low wages, it’s worth examining their alternatives, which include but are not limited to prostitution, scavenging, and outright starvation. According to a summary of research conducted by economist Ben Powell:

In Bangladesh, over 80% of the population live with a daily income under $2 a day. In India, it’s 60% of the population. For China, just over half the population earns under $2 a day. The average daily income of a sweatshop worker in Bangladesh is just over $2. For the Chinese sweatshop worker, it’s over $4 a day. The average Indian sweatshop worker earns $8 a day.\textsuperscript{514}

Also, in an interview, Powell states:

In six of the 17 countries [I examined], the average reported sweatshop wage exceeded the average income in the country… In another six countries, the average reported sweatshop wages were around the national average. In four of the five countries where sweatshop wages were 50 percent below the national average, the workers were immigrants (sometimes illegal) from other countries and their sweatshop wages exceeded the average wage in their native country.\textsuperscript{515}


Furthermore, “Edwin M. Graham of the Institute for International Economics found that the affiliates of U.S. multinational corporations pay on average twice the local wage in the developing world.”\textsuperscript{516} These findings give us a much needed sense of perspective. While the media and the public may condemn a company like Nike for utilizing sweatshop labor, the truth is that Nike, and companies like it, are providing employment opportunities to those who desperately need them and would be in worse circumstances without sweatshop employment. Research also finds that the western perception of “exploitative” multinational corporations is misguided. According to a review of the empirical literature on the matter conducted by economists at the National Bureau of Economic Research:

As an empirical matter, some anecdotal evidence notwithstanding, there is virtually no careful and systemic evidence demonstrating that, as a generality, multinational firms adversely affect their workers, provide incentives to worsen working conditions, pay lower wages than in alternative employment, or repress worker’s rights. In fact, there is a very large body of empirical evidence indicating that the opposite is the case. Foreign ownership raises wages both by raising labor productivity and by expanding the scale of production and, in the process, improves the conditions of work… This evidence indicates that multinational firms routinely provide higher wages and better working conditions than their local counterparts.\textsuperscript{517}


\textsuperscript{517} Drusilla K. Brown, Alan Deardorff, Robert Stern (2004): “The Effects of Multinational Production on Wages. and Working
On the topic of child labor, it’s worth noting that child labor has existed since the beginning of humanity’s, and without child labor many third world families would likely starve. For example, the International Labor Organization, has noted:

Poverty...emerges as the most compelling reason why children work. Poor households need the money, and children commonly contribute around 20 to 25 percent of family income. Since by definition poor households spend the bulk of their income on food, it is clear that the income provided by working children is critical to their survival.518

However, revelations like this didn’t stop people like Senator Tom Harkin from introducing legislation which would have banned imports from countries utilizing child labor in 1993. And what was the result of this action? According to Paul Krugman:

The direct result was that Bangladeshi textile factories stopped employing children [approximately 50,000 were fired]. But did the children go back to school? Did they return to happy homes? Not according to Oxfam, which found that the displaced child workers ended up in even worse jobs, or on the streets -- and that a significant number were forced into prostitution... The point is that third-world countries aren't poor because their export workers earn low wages; it's the other way around. Because the countries are poor, even what look to us like bad jobs at bad

wages are almost always much better than the alternative.\textsuperscript{519}

Child labor in third world families is not a choice, it is necessary for survival and is often the least undesirable option in a set of very bad options. Whoever is willing to jeopardize the employment prospects of third world children through child labor laws or by means similar to those pursued by Senator Harkin is basically willing to push these children into even more undesirable circumstances. The choices that those in the third world make are not between good and bad, but between bad and worse. As economist Eric Edmonds of Dartmouth once wrote:

> When destitution drives children to work, preventing the employment of children may do nothing other than further drive children and their families further into the despair of poverty.\textsuperscript{520}

Indeed, when destitution drives child labor, child labor laws should be expected to be either ignored or, if effectively implemented, incredibly damaging to families dependent on the income their children bring in. In fact, a 2014 study found that in 59 developing countries there was “little evidence” that child labor laws reduced child employment.\textsuperscript{521} In the end, the people who pretend to care about third world children and workers are often promoting


policies (like Harkins’) which effectively threaten their very livelihoods and survival. Paul Krugman was right when he wrote:

[Opponents of sweatshops and/or child labor] are not entitled to their self-righteousness. They have not thought the matter through. And when the hopes of hundreds of millions are at stake, thinking things through is not just good intellectual practice. It is a moral duty.522

“Taxes on the rich used to be over 70%!"

In responses to arguments that taxes on the wealthy could harm economic growth, many progressives tout the claim that tax rates on the wealthiest individuals were much higher than they currently are. For example, they argue, in the post-World War II period the economy boomed despite having a top marginal tax rate of over 90%. The obvious intention of this observation is to demonstrate that confiscatory taxes on the wealthy either have no effect on or boost economic growth. However, this “insight” is almost completely worthless since it ignores well known realities about the United States income tax and how it has changed over time, and it also doesn’t take into account other variables which affect economic growth.

Before we explore the details of this economic myth, one clarification is warranted. Throughout the following paragraphs the top marginal tax rate will be examined over time. The marginal tax rate is the tax rate which applies to income after a certain amount of it is earned. The top marginal tax rate is the marginal tax rate that applies to income earned in the top tax bracket.

For example, in the United States, the top marginal tax rate is currently 39.6%, the top tax bracket includes all income earned after an individual earns $406,750. Thus, every dollar of income earned after $406,750 is taxed at the 39.6% top marginal tax rate, whereas all income earned in different tax brackets is subject to different marginal tax rates (as shown in the table below). This clarification is important because it prevents one from inaccurately believing that the wealthy actually paid 90% of their income in taxes in the past. In reality, only a portion of a wealthy person’s income is subject is part of the top tax bracket and thus subject to the top marginal tax rate.

### Tax Brackets and Marginal Tax Rates in the United States

<table>
<thead>
<tr>
<th>Tax Year:</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Filing Status:</td>
<td>Single</td>
</tr>
<tr>
<td>If your taxable income is between...</td>
<td>your tax bracket is:</td>
</tr>
<tr>
<td>0 and 9,075</td>
<td>10%</td>
</tr>
<tr>
<td>9,075 and 36,000</td>
<td>15%</td>
</tr>
<tr>
<td>36,900 and 89,350</td>
<td>25%</td>
</tr>
<tr>
<td>89,350 and 186,350</td>
<td>28%</td>
</tr>
<tr>
<td>186,350 and 405,100</td>
<td>33%</td>
</tr>
<tr>
<td>405,100 and 406,750</td>
<td>35%</td>
</tr>
<tr>
<td>406,750 and above</td>
<td>39.6%</td>
</tr>
</tbody>
</table>

Table Source: moneychimp.com

When discussing top marginal tax rates it’s extremely important to examine how the top tax bracket changes over

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time. For example, during Ronald Reagan’s presidency, top marginal tax rates were lowered quite tremendously, but so were the top tax brackets. In 1981, when Reagan took office the top marginal tax rate was 70% and it applied to individual income earned after $548,000 (in 2014 dollars).524 By the end of his presidency however, the top marginal tax rate was 28% and it applied to individual income earned after $59,000 (in 2014 dollars). The same thing occurred during the Calvin Coolidge’s presidency during the roaring twenties, top marginal tax rates were lowered and the income subject to the top marginal tax rate was increased (as shown below).

<table>
<thead>
<tr>
<th>Tax Year</th>
<th>Tax Rate (%)</th>
<th>Income above which the top rate is applicable (in 2014 dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1921</td>
<td>73%</td>
<td>$13.3 million</td>
</tr>
<tr>
<td>1922</td>
<td>58%</td>
<td>$2.8 million</td>
</tr>
<tr>
<td>1923</td>
<td>44%</td>
<td>$2.8 million</td>
</tr>
<tr>
<td>1924</td>
<td>46%</td>
<td>$6.96 million</td>
</tr>
<tr>
<td>1925-1931</td>
<td>25%</td>
<td>$1.4 million</td>
</tr>
</tbody>
</table>

In contrast, in times of very high top marginal tax rates, one had to earn millions of dollars before his or her income became subject to the top marginal tax rate. For example:

- During the late 1930’s, an individual had to earn $84.5 million (in 2014 dollars) before his income started being subjected to the top marginal tax rate of 79%.525


525 Ibid.
• From 1944-1963 an individual had to earn between $2.4-2.8 million (in 2014 dollars) before his income started being subjected to the top marginal tax rate of over 90%.  

• During the 1970’s an individual had to earn $1.5-$3 million (in 2014 dollars) before his income started being subjected to the top marginal tax rate of 70-77%.  

• See the table on the next page for more:
So while it may be true that top marginal tax rate were quite high during times of rapid economic growth, like the 1950’s and 1960’s, these high top marginal rates applied to a much

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smaller percent of total taxable income than when the rates were lower. Thus, we wouldn’t expect the economic impact of these high top tax rates to be very large since they apply to a small amount of income. Nor would we be able to observe the impact of such tax rates without accounting for other determinants of economic growth and testing for the direction of causality.

However, there is a greater reason why we shouldn’t take the economic myth in question seriously, and that reason is that the *statutory* top marginal tax rate, which is the tax rate the government says an individual must pay and the type of tax rate we have been examining thus far, is not the tax rate individuals actually pay. The tax rate that individuals pay *after* accounting for tax credits, deductions, etc is the rate they actually pay and is known as the *effective* tax rate.

Source: Congressional Research Service
A graph produced by the Congressional Research Service (below) shows the **statutory** (top line) and **effective** (bottom line) top marginal tax rates over the course of United States history from 1966 onward.\(^{529}\) It is clear that the top marginal tax rate that wealthy individuals actually paid has historically been much less than the statutory rate. Research that has estimated the effective rates prior to 1966 has found that they too have been far lower than the statutory rates and never higher than 31%.\(^{530}\)

This revelation completely debunks the claim that taxes on the wealthy were significantly higher in the past than they are today. Also, as previously noted, tax brackets have

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changed tremendously over time, and the effective top marginal tax rates shown in the graph above don’t account for that. From 1944-1963 an individual had to earn between $2.4-2.8 million (in 2014 dollars) before his income started being subjected to the top marginal tax rate, which effectively was about 25%. In contrast, today a person has to earn just $406,000 before his income starts being subjected to the top marginal tax rate, which effectively is a little above 20%. Basically, the non-millionaires of today are paying similar top marginal tax rates that multi-millionaires in the past used to pay.

Anyone comparing statutory tax rates of the past to those today is ignoring or is ignorant of the fact that statutory rates aren’t the tax rates actually paid by individuals and that the United State income tax has changed tremendously over time. The claim that the wealthy paid over 90% of either their total or marginal income in the past simply isn’t accurate. In reality, the effective top marginal tax rate has always been much lower than the statutory rate and the percentage of taxable income subject to the top marginal rate has changed dramatically over time, making simple comparisons of top tax rates over time almost entirely useless.

Since this myth is often cited as proof that high tax rates on the wealthy won’t harm economic growth it’s worth noting what more sophisticated research actually says on the matter. Economist Karel Mertens of Cornell University examined how taxes on the wealthy have affected growth in the United States over the 20th century. According to Mertens, “A top marginal rate cut raises real GDP by up to 0.3 percent after two years and also has a positive effect on
incomes outside of the top 1%.”\textsuperscript{531} Recently published research from Victoria Business School examined how income taxes affected growth in developed countries and concluded by stating:

[There is] robust evidence that increases in the marginal rate of personal income tax, as measured by the top rate, and (less robustly) the average labor tax rate, are associated with adverse long-run growth outcomes [in OECD countries].\textsuperscript{532}

\textbf{The Myth of Scandinavian Socialism}

The Scandinavian countries, such as Sweden and Norway, utilize an economic system known as the Nordic model, or Nordic capitalism, which combines a large welfare state with free market policies such as openness to trade, minimal regulation, etc. In short, they are market economies with welfare states. While it is true that the Scandinavian countries have large tax burdens, and it is true that these countries experienced rapid growth in the 1990’s, it is not true that they are proof that a large tax burden does not harm economic growth. In fact, in order to examine how taxes affect economic growth, it is necessary to account for other factors which affect economic growth as well. For example, openness to trade, the size of the economy in question,


inflation, and other factors all affect economic growth. If we don’t take these confounding factors into account the correlation is meaningless, as is the claim that Scandinavian countries are proof that taxes don’t harm growth.

As noted earlier, several studies have examined the relationship between tax revenue as a percentage of GDP and economic growth in developed countries (including the Scandinavian countries). As noted earlier, a survey of these studies found that after confounding factors were accounted for, most research finds that an increase in tax revenue as share of the economy by 10% is associated with a decline in the rate of economic growth by 0.5% to 1%.533

The authors of this survey also examined why countries like Sweden seemed to grow rapidly despite high taxes. According to them, such countries, including the Scandinavian countries, compensate for high taxes with market-friendly policies in other areas. Additionally, they note that high levels of social trust are found to increase economic growth significantly, and that the Scandinavian countries have some of the highest levels of social trust among developed countries:

… in most studies… [a] 10 percentage points higher trust [level] is associated with half a percentage point higher annual growth rate. In the Scandinavian countries, about 60 percent agree that most people

can be trusted, which can be compared to the OECD average of about just 40 percent.\textsuperscript{534}

Interestingly, research also finds that countries with higher levels of social trust also have lower business and credit market regulations.\textsuperscript{535} Ultimately, the Scandinavian countries’ economic success can be attributed to their historical openness to trade and other market–friendly policies as well as their high levels of social trust. They are also no proof that a large tax burden won’t be a detriment to economic growth.

\textsuperscript{534} Ibid.