

## Washington's war on rich may be costly

Targeted tax rises are likely to prolong the financial crisis, writes David Smick.

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THERE is a reason people say, "Beware what you wish for because you may get it".

For years, the world has wanted Americans to consume less and save more. They are getting their wish. The US savings rate, near zero less than a year ago, has soared to nearly 5 per cent of income and could go higher. Total personal savings jumped from \$US20 billion in the first quarter of 2008 to \$US453 billion (\$A580 billion) in the same period of this year. The danger is if the savings rate goes to 7 or 8 per cent. If that happens, economic recovery could be seriously delayed.

When financial markets are working efficiently, saving is a good thing. But today, with major US industries at risk of meltdown, Americans desperately need to consume. Yet households are in a defensive mode because the financial crisis has destroyed \$US14 trillion of their wealth.

Consumption comprises 70 per cent of the US economy. While the reckless consumption of the past hardly made sense, the fear now is that American spending patterns are on a long-term decline. That means potential economic growth in years ahead could be very low (unless the financial system miraculously recovers and business investment picks up the slack).

The role of upper-income earners has become crucial to savings. There is an undeniable "trickle down" aspect to the workings of our economy. Like it or not, those making more than \$US100,000 a year are responsible for half of American retail sales and 70 per cent of the profit margins at retail, according to a study by American Express Publishing and researcher Harrison Group. Suddenly, because of the economic crisis, this group has become highly cautious about spending and their savings rate has soared.

The question is whether Washington is demonising the very people capable of leading the US out of recession. Affluent Americans have become the new political whipping boy. They are perceived as the illegitimate recipients of the ill-gotten proceeds of financial liberalisation and are about to face stiff tax rises.

There are serious policy questions about whether Washington's latest political fad of class warfare is on a collision course with the goal of economic recovery.

The annual affluence study by Ipsos Mendelsohn found that while the economy and climate change were of primary importance to average-income earners, taxes had become a major concern to suddenly cautious high-income earners.

A related question centres on the degree to which upper-income earners are worried about America's ballooning national debt. Federal spending next year will reach 28 per cent of US gross domestic product. It has exceeded 25 per cent of GDP only four times in US history.

When economic historians look back at this period, it will be enlightening to see whether today's debt explosion was responsible for high-income earners significantly increasing their savings in anticipation of potential tax and inflationary changes resulting from the debt.

American consumers are saving frantically, with high earners leading the way. The banks are barely lending and exports have collapsed. That leaves one option for raising demand if the economy fails to fully recover: more fiscal stimulus. With congressional mid-term elections less than a year away, a second fiscal stimulus early next year isn't out of the question.

US policymakers could face a tough choice. Would even a \$US1 trillion stimulus package be enough to impress consumers who have lost 14 times as much? Moreover, would a serious negative wealth effect result among high-income earners if the national debt rises to even higher levels?

Policymakers need to ask which development over the past few months has the greater potential to revive the economy: the \$US800 billion stimulus package that produced millions of rebate cheques worth several hundred dollars; or the \$US3 trillion sharemarket jump (since the March 9 low) that has relatively cash-rich Americans looking at their retirement accounts with some relief for the first time in a while?

Ultimately, the factor determining the success of the economy will be the level of private demand for durable goods by the end of next year. Success will require a lot of spending by high-income earners the President probably doesn't like and who probably don't like him.

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