

## **Eye on the economy**

### **Lifting all boats with a rising tide**

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The trickle-down effects of tax policies favouring businesses and high-income earners have long been a contentious subject.

Proponents of this trickle-down effect say low taxes leave business owners with more cash to expand their businesses. Top earners will also be motivated by higher incomes to spend more time at work. In short, the trickle-down effect assumes that what is good for the wealthy is good for the economy and, hence, also for the poor, a proposition which United States president John Kennedy described as "a rising tide (that) lifts all boats".

The US top tax rates were as high as 76 per cent in the 1930s to help finance president Franklin Roosevelt's New Deal. In the 1940s, it rose to 94 per cent to pay for the war. By the 1950s, the highest tax rate was still over 80 per cent.

Aggressive changes in the tax codes really began in 1981, when president Ronald Reagan lowered the individual tax brackets by 25 per cent and changed the way companies accounted for capital expenditures in order to encourage investment in equipment. In 1986, the top rate was further cut from 50 per cent to 28 per cent, while corporate tax was reduced from 50 per cent to 35 per cent.

The tax-cutting trend was reversed in 1993 by president Bill Clinton, who raised taxes modestly but lowered the maximum tax rate for capital gains. In 2001 and 2003, president George W. Bush again lowered the marginal tax rates, the maximum rate on long-term capital gains and the maximum rates for most dividends to spur economic growth. The tax cuts expired in 2010 but were extended by President Barack Obama for two years in view of the recession.

In general, even though tax rates applied to all income brackets, the rich benefited more. The tax cuts in 2001 and 2003, for example, saved the average middle-class taxpayer US\$744 a year, while saving US\$44,212 a year for the top 1 per cent of taxpayers and US\$230,126 for the top one-tenth of 1 per cent of households.

If the trickle-down effect really works, the increase in income inequality from tax cuts should have spurred economic growth which should in turn bring about income growth for workers at the lower rungs. But a 1994 study using World Bank and Organisation for Economic Cooperation and Development (OECD) data from 65 industrial nations revealed that inequality in income and land ownership is empirically shown to be negatively correlated with subsequent economic growth. Countries where higher shares of national income went to the top 5 per cent to 20 per cent of earners achieved lower growth rates.

More recent research last year using data from 18 OECD nations also demonstrates a strong correlation between cuts in top tax rates and increases in the top 1 per cent income share since 1975, especially in English-speaking countries.

Furthermore, the increases in top income share have also not translated into higher economic growth, just as the 1994 study concluded. In fact, developed countries

have all grown at almost the same rate even though there were huge variations in tax policies over the past 30 years. For example, the US and the United Kingdom, which made substantial reductions in top tax rates in the early 1980s, did not see significantly faster growth than Germany and Denmark, which retained their structures of high taxes.

This suggests that gains at the top may have taken place as a result, not of increased productive efforts, but of effective compensation bargaining by top earners, and were at the expense of low-income earners. Economists from Auburn University demonstrated this zero-sum proposition in 2009. Based on regressions of Gini coefficients, wages, proprietor incomes and corporate profits, the research found that there was no trickle-down from proprietor incomes and corporate profits to workers in lower-income groups.

Indeed, income inequality has progressively worsened in the US over the decades. National output doubled between 1979 and 2005 and rises in after-tax household real income were 6 per cent for the bottom fifth of income earners and 21 per cent for the middle fifth. But it was 80 per cent for the top fifth and 228 per cent for the top 1 per cent. From 1970 to 2007, the share of total income going to the top 1 per cent of income earners rose dramatically from 9 per cent to 23.5 per cent.

In contrast, despite healthy profit growth enjoyed by companies, total employee compensation rose less than one-fifth as fast. In 2006, corporate profits as a share of national income were the highest since the Great Depression, while the share of employee compensation slid to its lowest since the 1960s.

Even though there is a federal minimum wage, the stipulated US\$5.15 in 2007 was 33 per cent below its 1979 level after adjusting for inflation. Between 2000 and 2006, the number of Americans in poverty rose by 15 per cent. About 33 million workers earned an annual income of US\$20,614, which is below the poverty level. One contributing factor is the decoupling of pay from productivity. Workers' productivity rose 15 per cent during the period, while corporate profits rose 13 per cent per year. But average wages remained virtually unchanged.

Proponents of the trickle-down effect are quick in pointing out the already progressive nature of the income tax system. In 2009, the average effective tax rate of households in the lowest quintile was only 0.1 per cent compared with the 23.2 per cent for the highest quintile and 28.9 per cent for the top percentile. The highest household income quintile therefore paid 67.9 per cent of total federal taxes, even though their share of total before-tax income was 50.8 per cent, while the lowest quintile paid only 0.3 per cent. Top income earners are already facing a higher federal tax rate and shouldering a tax burden bigger than their share of income.

It is not that the trickle-down effect has never benefited workers at the lower rungs. From 1947 to 1973, for example, productivity and the average wage in the US rose more or less in tandem, with each roughly doubling. Income inequality narrowed considerably during the decade of Great Compression in the 1940s but began to increase marginally during the 1950s and 1960s.

By the 1970s, Great Compression gave way to Great Divergence, when income inequality began to widen noticeably while wage growth for workers on the lower rungs started to slow. By the 1980s, the redistributive effect of taxation, significant prior to 1982, due to high tax rates, began to ebb as the US government cut taxes as advocated by supply-side economics. The decline was further accentuated in 1986

by a 60 per cent long-term capital gains exclusion and in 1997 by a lowering of the maximum tax rate on capital gains.

As a result, many wealthy Americans, who receive a substantial portion of income from investments, pay less in federal taxes than middle-class Americans. Presidential candidate Mitt Romney, for example, announced that his federal taxes for last year would amount to 15.4 per cent of his income, a rate that is closer to what the middle-quintile households are paying. Billionaire investor Warren Buffett also claimed that he paid taxes at a rate lower than that of his secretary.

The aggressive cutting of taxes not only did not lead to higher economic growth or higher wages for low-income workers, it also weakened the redistributive effect considerably. The growing disillusion impelled Mr Obama to declare that "the old trickle-down theory has failed us" in a presidential campaign ad in 2008. Since then, Mr Obama has been pitching for a more progressive income tax structure not only to close income gaps, but also to help reduce the shortfall in the budget. His desire to raise taxes especially for high-income earners is underpinned by his conviction that the country's prosperity does not come from top down, from rich to poor, but from having a strong and growing middle class.

With re-election uncertainty behind him, the President can now work to reform the tax system. This includes extending Bush-era tax cuts to 98 per cent of households in the middle class while raising tax rates for those with earnings over US\$250,000 (S\$306,000), phasing out personal exemptions, treating dividends as ordinary income, setting long-term capital gains at 20 per cent, and cutting corporate tax from 35 per cent to 28 per cent to stimulate job creation.

More importantly, Mr Obama also needs to review the institutional frameworks that have contributed to the lopsided income distribution so that a fair share of the gains from the next upswing can again trickle down, as was the case before 1973, instead of trickling disproportionately up to the wealthiest. A more equitable distribution system from the onset will negate the need for subsequent, politically more contentious, redistribution.

Just as Reaganomics made the US a model of small government and low taxes, hopefully Mr Obama's more interventionist approach this time round will inspire other governments besieged by problems of widening income inequality to follow suit.

Given deeply entrenched bipartisan politics, structural US economic weaknesses and the perilous social rift between haves and have-nots, Mr Obama's efforts to tackle rising debt, languishing growth and widening inequality will be nothing short of monumental.

The price of failure or impasse will be enormous, not only for Americans, but also for the already embattled global economy.

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