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A Proposal to Solve the Trade Problem
Without Lowering Our Standard of Living

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America has a trade problem. Exports of goods and sales of services may fall short of imports by as much as $150 billion dollars in 1985, topping the record $108 billion merchandise trade deficit for 1984. Imports have increased more than one-third since 1980, while exports have stagnated.

Many people are bemused by these numbers and neglect the influence of past inflation on the numbers they read. The net export deficit of $94 billion in this year's second quarter shrinks to $34 billion when expressed in 1972 dollars. There is still a challenge, but as recently as 1980, the United States had a trade surplus of more than $50 billion in the same 1972 purchasing power.

Trade has become a major political issue because the growth of imports has adversely affected important segments of American industry. As usual when problems are serious enough to get political attention, many of the proposed solutions, if enacted, would be worse than the problem. The rush by Congress toward protectionist legislation to restrict or tax imports is a case in
point. So, too, are the administration's proposals to subsidize exports and the attempt by Secretary Baker to lower the value of the dollar by intervening in the foreign exchange market.

These proposals have two common features. They ignore the main cause of the trade problem and treat the symptoms. And, if adopted, they would lower the standard of living.

While there are many causes of the trade deficit, the most important cause is the most neglected. The Reagan tax cuts of 1981 and lower inflation raised the expected, risk adjusted, after-tax return to capital. This had two effects. Foreigners wanted to invest more here, and American banks, businesses and individuals wanted to invest less abroad. The result was a sharp turn in capital exports once the economy began to recover. Instead of exporting capital to the rest of the world by lending and investing abroad, we imported capital from the rest of the world, borrowing to finance investment, consumption and the government budget deficit.

Latin American debt problems reinforced the effect of the tax cuts by reminding domestic lenders pointedly about the risks on foreign loans. And the lagging growth and weak recoveries in Europe continued to make the U.S. appear a relatively attractive place to invest even after our growth rate slowed.

The trade deficit is the mirror image of our net capital imports. As long as the U.S. remains a relatively attractive place to invest, people everywhere want to earn the higher returns available here. The dollar falls when the growth of the U.S. economy slows relative to foreign economies. Evidence of renewed strength in the economy, relative to others, appreciates the dollar and raises interest rates.

The dollar reached its peak in February 1985, when there was widespread
optimism about U.S. economic performance this year. As the dollar soared, the stock market surged, and interest rates rose. When second thoughts discarded this optimistic view, the stock market boom ended, and the dollar fell.

If growth rates in Europe or other large economies rise as our growth rate declines, the U.S. will attract less investment from Europeans, Japanese and others. Overseas investments will seem more attractive. If the U.S. no longer has the highest, risk adjusted, expected after-tax return to capital, capital will flow out. The capital account surplus and its mirror image -- the trade deficit -- will fall.

Politicians, some businessmen, and workers in industries like textiles, shoes, tires, autos and steel don't want to wait for these processes to work their way through the markets of the world. They are as impatient with facts and arguments as with the past reluctance of Congress and the administration to slow or stop imports. Understandably, they do not want to be the victims of a strong dollar if they can shift the cost to others. Most are unmoved by the fact that the rest of the world is lending us money to rebuild our economy or by the argument that rebuilding would be faster, if the government would reduce its spending. To people competing with imports, the trade balance is not just the symptom of the capital inflow; it's the problem.

Protectionist legislation that puts quotas, taxes or tariffs on imports tries to solve the problem by raising the prices that consumers pay for imports. Higher prices reduce purchasing power and living standards. Even if, by some miracle, retaliation is avoided, consumers would lose the option of buying the goods they prefer, at attractive prices, and producers would lose some of the incentive they now have to compete with foreigners by increasing productivity and improving product quality. Restrictions on imports of steel, machinery or semi-finished goods also lower the standard of
living by raising prices and by putting domestic producers at a disadvantage. Cars, trucks or buses made with higher priced domestic steel are more expensive than foreign cars made with lower priced foreign steel. The consumer gets less value for his money.

The recent decision by the finance ministers of Germany, France, Britain, Japan and the United States, under the leadership of Treasury Secretary Baker, to push the dollar down by intervening in the currency markets is not a solution. Intervention can make exports cheaper, or imports more expensive, temporarily, by raising money growth and inflation above the rates now anticipated. People living on a fixed income or working for a fixed wage will find their living standards reduced. Production costs will be lower temporarily. Gradually, wages and other costs will reflect the higher inflation, just as they did following the inflation and currency depreciation of the 1970s. The only lasting effect of inflation and currency depreciation on the trade balance would come because taxes, especially taxes on capital, increase with inflation. This lowers the after-tax return to investment, so capital would leave the United States to seek higher returns elsewhere. The mirror image of a capital outflow is a trade surplus. Again, we "protect" our trade account by lowering our standard of living.

The Administration's recent proposal to subsidize exports is just another in a long list of dreary schemes to reduce the trade deficit by lowering the standard of living. Export subsidies tax domestic consumers so that foreigners can buy the products we produce at less than their market price. We export more, but our after-tax incomes are lower.

Many expressed concerns about the trade deficit are really concerns about the mix of products we produce. The current economic recovery has favored the service sector relative to the manufacturing sector. The strong dollar has
humbled manufacturers who must compete in third countries and at home against producers who pay lower wage rates in relation to worker productivity. This is an often told tale. Japanese automobile producers, Korean steel producers, Chinese or Hong Kong textile producers and many others have lower productivity than American producers, but their costs of production are lower still. The various schemes to tax imports, subsidize exports or drive down the dollar try to meet this lower cost competition by reducing the costs or prices of our exports or raising the prices of imports.

The challenging task is to strengthen the manufacturing sector while maintaining or raising our current living standard. This challenge can be met if, instead of reducing standards of living, we raise productivity. To compete effectively, we have to increase efficiency, not reduce efficiency by imposing tariffs and quotas or subsidizing exports.

The effective way to compete with countries that have lower wage costs, is to have lower capital costs by removing taxes on capital. Instead of reducing taxes for consumers and raising effective corporate taxes on investment, as the Administration has proposed, we should eliminate, or substantially reduce the corporate income tax and lower the capital gains tax. A more radical plan would replace all taxes on corporate profits and individual incomes with a flat tax on consumption.

Eliminating the corporate income tax would reduce the government's revenues by about $60 or $70 billion but would increase investment, the amount of capital per employee, and productivity. If tax reduction is spread over two or three years, the amount of spending reduction or loophole closing required to match the government's revenue loss would be far less than the amounts contemplated in the Administration's most recent tax and spending proposals.
The current, corporate marginal tax rate is 46%. At this tax rate a new investment must produce nearly two dollars of cash flow for each dollar of after-tax return to the firm. Allowing for the investment tax credit and other investment incentives lowers the average marginal tax rate on new investment to about 35%. Using this tax rate and current interest rates, projects must earn rates of return of 20% or 25% before tax to justify investment.

Elimination of the corporate income tax would have dramatic effects on the cost of capital. Investments that yield as little as 12% or 15% would be attractive. Corporations would invest more in capital, including projects that pay out over longer periods. Manufacturing industries that have been hurt by the high dollar would benefit most.

Some will view this proposal as impractical or politically infeasible. Reducing corporate taxes to aid manufacturing smacks of "trickle down". Hard choices are always politically difficult. In this case, the principal alternative is to lower the standard of living. If the choice is put that way, as it must be, the alternative is even less attractive.

The administration's tax plan has many merits as well as many deficiencies. The main problem is that it is the wrong plan for our current circumstances. It expands consumption, relative to investment. To compete with countries that have low cost labor, while maintaining or increasing our standard of living, we must have low cost capital and high productivity. President Reagan once recognized that we should get rid of the corporate income tax. His administration should recognize that now is the best time to take his advice. Eliminating taxes on capital may not eliminate the trade deficit, but it will reduce the pressure on the manufacturing sector without reducing living standards for everyone else.