Tax Cut is Bad Medicine for the Trade Deficit

By

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President Bush has sold his tax cut as a cure-all for the multitude of ills facing the U.S. economy. We've heard how the tax-cut elixir will support a sagging economy in the short run and stimulate productivity in the long run; how it will help motorists afford higher gas prices at the pump this summer and take the sting out of rising electricity rates.

But one problem the tax cut won't solve and, in fact, will make worse, is the rapidly expanding trade deficit. From a level of just over $100 billion in mid-1997, the gap between imports and exports ballooned to over $450 billion by the end of 2000. This unprecedented deterioration was driven by several factors, including the collapse of Asian demand for U.S. exports during the currency crises of 1997-98, faster growth at home than abroad which fueled America's appetite for imports, and a strengthening value of the dollar which eroded the competitiveness of U.S. exports.

Enormous as it is today, however, the trade gap, would have been larger still if not for the responsible shift in Federal budget policy during the 1990s. The tax increases and spending caps of 1990 and 1993 were instrumental in placing budget policy on a path of emerging surpluses. This shift toward a more restrictive fiscal policy took some of the stream out of an overheating economy in the late 1990s and helped restrain imports. It also reduced the government's need to borrow, thereby freeing funds for the private sector's investment spending spree. And, by keeping interest rates lower than otherwise, the shift in budget policy helped limit the strengthening of the dollar.

Trade deficits force Americans to borrow from abroad to finance the difference between receipts for exports and payments for imports. In recent years, this borrowing has caused the foreign debt to grow a lot faster than the economy, with the debt rising from about 5 percent of GDP at the end of 1995 to nearly 20 percent by 2000. Although much of this borrowing helped pay for the capital spending boom of the late 1990s, the rapid increase in debt leaves the U.S. economy vulnerable to a sudden shift away from dollar investments by foreign investors. Such a shift would lead to a swift decline in the dollar's value, roiling financial markets and bringing on a surge in import prices. For an economy struggling to recover from the collapse of the internet "bubble," a pullback by foreign investors could push the economy into a full-blown recession.

The recently enacted tax cut abruptly alters the fiscal landscape by lowering anticipated budget surpluses. By itself, the tax cut will ratchet the budget surplus

downward by $1.3 trillion over the next 10 years, reversing the restraint that fiscal policy has had on the trade deficit. And given the likelihood that spending for a prescription drug program, defense, and education will exceed current low-ball estimates (not to mention the need to revisit the alternative minimum tax and restore tax provisions due to expire), the fiscal picture is decidedly worse than the headline numbers. This shift to lower budget surpluses–and the possible reemergence of budget deficits–represents a fall in national saving that is likely to be offset by increased foreign borrowing and a rising trade deficit.

One need only revisit the record of the 1980s to understand how a shift in fiscal policy can quickly worsen the trade deficit. From 1981 (the year of the Reagan tax cut) to 1986, the Federal budget deficit increased from $79 billion to $221 billion. Over the same years, the trade deficit climbed by a similar amount, rising from roughly zero to nearly $150 billion. The increase in foreign borrowing associated with the trade gap financed the burgeoning budget deficit–a far less productive use of foreign money than the high-tech investment boom of the late 1990s.

In the end, a sharp drop of over 30 percent in the dollar's value from its peak in 1985, along with the recession of 1990-91, served to reduce the trade deficit and slow the pace of foreign borrowing. But the gyration in the dollar's value created havoc for many exporters and importers by upsetting their long-range investment plans.

Trade deficits are beneficial when they allow society to invest more than its saving and reap gains in productivity, wages, and the standard of living. But they are ill advised when they merely substitute for other types of national saving or leave us vulnerable to shifts in investor sentiment.

Like its predecessor of 20 years ago, the latest tax cut will reduce national saving and increase the need to borrow from abroad. But unlike its predecessor, it comes on top of a buildup in foreign debt that is enormous and unsustainable at its current pace. This mountain of foreign debt means that adjustment this time around is far more likely to be disruptive than in the 1980s. And, with the European currency, the euro, now representing a viable alternative to the dollar, investors today may find it easier to quickly pull their money out of dollars than in the past. Get ready for a wild ride!

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