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Policy Brief

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Can the World Economy Afford American Tax Cuts?

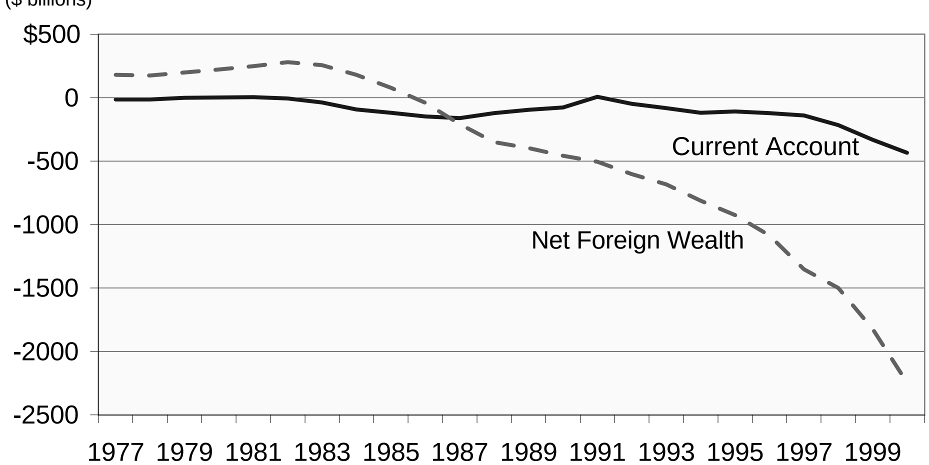
Ronald McKinnon

Once taxes are cut and the corresponding tax codes rewritten, they are hard to reverse. Although the timing of the tax cuts in 2001 may seem fortuitous for stimulating domestic spending over the next year or two, they should be crafted with an eye to the more distant future. And the principal longer-term structural problem facing the American economy is deficient national savings, where net personal saving by households is close to zero.

Over the past decade, personal saving has fallen more than government saving (as manifested in budget surpluses) has increased. The huge deficit in the current account in the U.S. balance of payments, about 4.5 percent of GNP in 2000, reflects this saving gap. In order to support a normal level of domestic investment, i.e., historically about 17 percent of U.S. GNP, America has had to draw heavily on the saving of the rest of the world. Thus, the "wrong" kind of tax cuts, i.e., those that reduce government saving but fail to stimulate private saving, could worsen this foreign indebtedness.

The U.S. Current Account and Net Foreign Wealth Position

1977-2000



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The International Dollar Standard and America's Soft Borrowing Constraint

The United States has moved from being a net creditor to the rest of the world at the beginning of the 1980s to being the largest net debtor—to the tune of an incredible $2,300 billion by 2000.

Should Americans worry? After all, the dollar remains strong and the United States is unique in having a virtually unlimited line of credit, largely denominated in its own currency. Consequently, American banks and other financial institutions are relatively immune to currency risk.

This provision of international money, i.e., providing the central currency in the world system, is a natural monopoly. Once settled on for whatever historical reason, the dollar offers huge economies of scale for its continued use as the central vehicle in international exchange. (The major exception is the strong regional role played by the euro for countries on the fringe of the EU.) In effect, the dollar could now only be deposed by some cataclysmic event—such as massive inflation in the United States.

Although this central monetary role for the dollar is good for promoting more efficient international exchange, an incidental consequence is that the United States itself is given a much softer budget constraint on its own international borrowing. As the rest of the world's income grows, the demand by foreign enterprises and governments to build up their stocks of international liquidity rises commensurately. So America can provide these liquid dollar assets, which are claims on American firms and households, *with no well-defined time frame for net repayment.*

If, in the new millennium, the United States could return to current-account balance or even began to run surpluses, the rest of the world could still get the liquidity it needed quite comfortably. But if we accept the hypothesis put forth here that the American line of credit with the rest of the world is indefinitely long, why not just keep borrowing to cover current-account deficits? Wouldn't American consumers be better off if they continue to borrow indefinitely to keep their expenditures above their incomes?

Financial Fragility

There are two big problems with continuing the status quo ante of running large current-account deficits: declining creditworthiness of American households and firms and increasing protectionism.

The over-leveraging of American households is aggravated by banks and consumer credit companies financing themselves too cheaply on international markets. The resulting incredibly low net worth of American households with moderate incomes makes the macro economy less stable.

To a degree, the American corporate sector is less vulnerable to over-leveraging from the economy's soft borrowing constraint in international markets. Foreigners can and do buy equity claims on American corporations. Thus the debt-to-equity ratios in most American companies need not rise as a result of foreign capital inflows.

However, nobody, including foreigners, can buy equity claims on American households! Thus, insofar as the influx of foreign capital softens household budget constraints, it takes the form of a greater buildup of household indebtedness. Although heavily indebted American households don't seem to be borrowing from foreigners, they are doing so indirectly as intermediated by domestic banks and finance companies.

Resurgent Protectionism?

Foreign saving can only be transferred to the United States through large American current-account deficits. Because of the heavy state intervention and protectionism for agriculture and some services around the world, the industrial sector typically bears the brunt of adjustment to swings in the trade balance.

As a result, American manufacturing industries must contract on both the export and import-competing sides. Boeing will have a much tougher time competing against Airbus Industrie in aircraft, Caterpillar against Komatsu in heavy equipment, and so on. Where the United States has a technological lead in computers, integrated circuits, and Internet-related equipment, American firms will farm out production to overseas affiliates more rapidly.

A purist might say, "If this is what the market dictates, then so be it." But in some sense "the market" is biased by international monetary considerations that give the United States a uniquely soft long credit line with the rest of the world—which in turn has led to an unusual shrinkage in its industrial base.

More important, the political obstacles to preserving free trade are increased when the trade deficit is large. First, a relatively small American export sector reduces the support for free trade. The second is the perception, whether or not it is correct, that a large trade deficit reflects "unfair" trading practices by foreigners—and that the government should do something offsetting to protect American industry.

During the "Goldilocks" period of the American economy, from 1995 through 2000, these underlying protectionist pressures were dampened by the unusually low rate of unemployment and the economy's rapid rate of growth. But with the downturn in the U.S economy in 2001, protectionism in the form of Japan or China bashing may well return. In the longer run, the political economy of preserving free trade on a world scale would be much easier to sustain if the center country's trade accounts came into better balance.

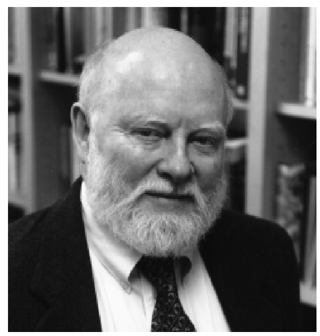
Tax Cuts the United States Can Afford

If today's large budget surplus, i.e., the government's contribution to national saving over 2 percent of GNP in 2000, were to be reduced by massive tax cuts without generating a substantial increase in U.S. personal saving, America's huge current-account deficit would increase.

An important aspect of the low personal saving problem is that Americans are putting aside far too little in their pension plans and then taking out too much. Both actions are tax driven. Tax "cuts" should take the form of much higher ceilings on personal tax deductions for pension saving, while allowing older people to accumulate indefinitely within their pension plans without facing tax penalties. Eliminating the estate taxes would further increase the incentives for American households to save in order to pass more wealth on to the next generation. Even more radical would be to introduce aspects of a low flat-rate income tax with no deductions—other than a generous personal exemption.

The bottom line is that, if one takes the balance of international payments into account, tax cuts that demonstrably increase the incentives for private saving should be at the forefront of what the new Bush administration is considering. But this is a lot to consider and perhaps too much to hope for.

About the author



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His fields of interest are international economics and development finance. McKinnon has written over 100 articles and several books, which include: *Money and Capital in Economic Development* (1973), *Money in International Exchange: The Convertible-Currency System* (1979), *The Order of Economic Liberalization: Financial Control in the Transition to a Market Economy*; 1993, *The Rules of the Game: International Money and Exchange Rates*, MIT Press 1996, *Dollar and Yen: Resolving Economic Conflict Between the United States and Japan* (with Kenichi Ohno) 1997.

His books have been translated into many European and Asian languages, and he has been a consultant to central banks and finance ministries the world over—including international agencies such as the World Bank and International Monetary Fund.