Texas Public Policy Foundation

TRADE

You Ain't Got the Frills If You Ain't Got the Skills

By Dr. Arthur B. Laffer

Thinking Economically

Lesson 6

Thinking Economically

Key economic concepts at the foundation of our market-based economy, such as value, entrepreneurship, and competition, often get lost in today's complex policy debates. Too often this results in unforeseen consequences that no one involved intended to bring about.

Thinking Economically is a project of the Texas Public Policy Foundation designed to provide a basic economic education for policymakers, the media, and the general public. In this way, the Foundation hopes to highlight the intersection of economics and public policy, and the importance of "thinking economically" when making policy decisions. We are grateful to be able to undertake this project with the assistance of Dr. Arthur Laffer, who has throughout his distinguished career shaped the thinking of many world leaders by bringing sound economic thought into policy debates and the public's awareness.

Texas Public Policy
FOUNDATION

Thinking Economically

In recent years, more and more commentators pontificate on the alleged "gross imbalances" in the world economy, as epitomized by the U.S. trade deficit. The hysteria has reached such a crescendo that there is actually a new book entitled *A Year Without "Made in China"* which chronicles the challenges to an American family that tries to go 12 months without using anything imported from the sinister country. Yet to an economist, these exploits are akin to going a year without electricity or indoor plumbing. In this chapter I hope to show you why.

Both Parties Benefit From a Voluntary Trade

Like great literature, trade theory can be a deep topic, offering a lifetime of intellectual discovery. On the other hand, its basic premises are simple enough. Whenever the discussion of deficits and currencies becomes maddening, it always helps to remind ourselves: *people only agree to trade because they expect to benefit from it*. This principle is true whether the trade is between Joe from Brooklyn and Mary from Queens, or if the trade is between Abu from India and Claude from France. The discussion gets emotional when different countries are involved, but the economics remain the same: the laws of supply and demand don't care about geographical boundary lines. For this reason we'll first consider the case of trade between two individuals in the same region, and then extend the analysis to several individuals who reside in different countries.

The basic premise of trade theory is simple enough: People only agree to trade because they expect to benefit from it.

Comparative Advantage and Specialization

Even if there were no production, people would still benefit from trading with each other, since each party gains something more valuable than what he gives up in the exchange. You see this wonderful process in action whenever siblings get home on Halloween and compare the stash of loot that each has acquired during the night. Because the children can always choose to eat their original collection of goodies, the possibility of trading away three Butterfingers for two Snickers can only make things better still. To repeat, so long as there is no deception or intimidation involved, trading always makes all participants better off because they could simply *refrain* from trading if they so desired.

But if trading is a great idea for rearranging a given stockpile of goodies, it's even more beneficial once we consider how people spend their time creating *more* goodies. When people know that they will have the option of trading

The possibility of trade allows a nation's workers to specialize in certain areas and then trade away the surplus product with other nations.

with others, it allows them to specialize in producing in areas where they excel, and then trading the surplus (above their own consumption needs) to acquire the things that they want but haven't personally produced.

Imagine a world without trade. Everyone would have to grow his own food, sew his own clothes, build his own house, and (to be really outlandish) give himself open heart surgery. But once we introduce the possibility of trade, people can specialize in occupations. To wit, some people (we call them "dentists") do nothing but drill cavities all day, while other people (we call them "farmers") do nothing but grow food. Because people have different skills and because different areas of the world are more favorable to particular industries, total output is much, much higher when people specialize than if they each tried to personally produce every item they wanted to consume. The end result? Trade allows a higher standard of living for everyone.

One of the most interesting findings of classical economics is Ricardo's so-called law of comparative advantage. The upshot is that even if we consider the position of someone who is totally superior in all occupations, that person *still* benefits from trading with someone else who is inferior in every single line of work. By focusing his efforts in those lines where he is *relatively* the strongest—i.e., the areas in which he has the *comparative* advantage—and then trading away the surplus to the less productive fellow, the superlative individual ends up consuming more than if he relied on his own efforts. Although it sounds paradoxical at first, the idea is actually quite obvious. A lawyer certainly benefits from hiring a secretary to handle his correspondence, even if he can type faster than she can. Or, a professional athlete certainly benefits from hiring a teenager to cut his lawn, even though he could undoubtedly get the job done more quickly. By outsourcing these tasks to others, the lawyer and athlete are free to devote more time to writing briefs and scoring touchdowns, areas in which they *really* excel (compared to the secretary and the teenager).

Everything we have said above about individuals holds true for entire countries—which after all are simply collections of individuals. It can only make the people in a region richer if they have the option to trade with the people in other regions. Rather than relying exclusively on its own workers and resources to produce everything its citizens desire, the possibility of trade allows a nation's workers to specialize in certain areas and then trade away the surplus product with other nations. The end result is a much greater total output and higher standards of living for everyone the world over. And again, this is true even for the advanced nations when they trade with backward ones—just as a brain surgeon doesn't become poorer if he decides to trade with the people working at Taco Bell.

Don't Fear the "Trade Deficit"

Even though economists have hammered away at the point for literally centuries, people still cling to the mercantilist fallacies that imports are bad and exports are good. This thinking leads them to recoil in horror at the so-called "trade deficit," which occurs when Americans import more goods than foreigners buy from our workers. As we'll see, this is utterly confused, and policies aimed at reducing our trade "imbalance" will only make Americans poorer. Ironically, it is precisely when the government enacts sensible, pro-growth policies that you will see the trade balance "worsen." Let's try to make sense of all this.

There is a close relationship between a country's capital surplus, its trade deficit and its terms-of-trade (often called the real exchange rate). A capital surplus is the difference between what's invested and what's saved in a country, while the trade deficit is the difference between what's consumed and what's produced in a country. Boiling it all down, a country's capital surplus is the same as the trade deficit. As I discuss below, it's a matter of accounting, pure and simple.

The trade balance (what I'm actually referring to here is the balance of the current account, which includes the balance on income services in addition to the trade balance) is not only the difference between what a country exports and what it imports, but it also is the difference between what is produced in a country and what is consumed in a country. For a country, income minus expenditure is the trade surplus. Income by definition is comprised of consumption and savings, while expenditure is consumption plus investment. The difference between income and expenditure, therefore, is also the difference between savings and investment, which in turn is another way of saying the net capital outflow. A capital surplus is one and the same as the trade deficit.

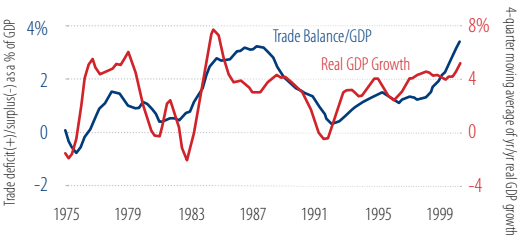
While accounting is not all that exciting, the various perspectives one gets from the accounting identities are interesting. In this world of ours the trade deficit is said to "worsen" if it grows and "improve" if it shrinks. This view leaves the impression that a country with a trade deficit is over-consuming and living beyond its means. While perhaps never stated officially, there is definitely more than a whiff of gluttonous indolence when speaking of trade deficits.

Foes of supply-side policies often focus on the trade deficit as a negative consequence of the tax cuts in the 1980s. Traditional economists believe that a long-standing trade deficit is a sure sign of an economy at risk. However, this belief has little historical support. To borrow a passage from a paper I wrote back in 1982:

> *The central tenet of much of the effort to improve the balance of trade is the belief that a trade surplus is indicative of a healthy economy with rising income and employment. This belief, however, is contradicted by the experience of the United States and other countries.*
>
> *Between 1790 and 1875, the U.S. merchandise trade account was in deficit 74 years, yet U.S. output increased enormously. During the post World War II era, an improvement in the U.S. trade account typically occurred during years of relatively poorer, not better, economic performance. In addition, periods of above-average growth are associated with a deterioration (not an improvement) in the trade account.*

The evidence suggests that trade deficits or deteriorations in the trade balance are desirable more often than not. In six of the 11 countries examined (including the U.S., the United Kingdom, and Japan) deterioration in the balance of trade is associated with a healthy, growing domestic economy demanding resources from the rest of the world. In only three of the 11 countries is relative economic growth associated with improving trade balances. Alarm and concern over rising net imports typically are unfounded. And efforts to correct trade balance deficits, if successful, often stifle rather than augment domestic economic growth.[*]

Figure 1: U.S. Trade Deficit(+)/Surplus(-) as a Percentage of GDP
(through 2Q2000, trade in goods and services)



Since 1982, the relationship between prosperity and trade deficits has not changed. Over the past two decades strong U.S. economic growth has continued to go hand-in-hand with deterioration of the U.S. trade accounts *(see Figure 1)*.

A trade deficit just sounds horrible—but a capital surplus sounds good! And yet a trade deficit *is* a capital surplus. Go figure! Having investors lined up on your borders trying to invest in your country is a lot better than having investors trying to get their investments out of your country. Capital inflows are driven by good economics. The better off that investors investing in your country are, the larger will be the capital surplus (i.e., trade deficit). While we all know that growth companies borrow money, it's also true that growth *countries* borrow money. Growth countries are where investors want to be.

Changing Terms of Trade: Good Policies Lead to "Worse" Trade Deficits

When a country cuts tax rates, deregulates its economy, reduces trade barriers, or follows sound monetary policy, the immediate effect is an increase in the after-tax rate of return on assets located in that country. If the country were the only country in the world, then it would follow that higher after-tax rates of return on assets would lead to an increase in the demand for those assets and asset prices would rise. In the very short-term there would be some combination of an increase in the after-tax rate of return on assets and an increase in the price of assets. Of course, if a country adopted policies that raised tax rates, increased regulations, raised tariff barriers, or debased its monetary system, then there would be an immediate decrease in the after-tax rate of return on assets in that country.

It's also quite easy to visualize what happens if there are two or more nations. Imagine that there are two nations, A and B, and taxes are cut in B and are not cut in A. Investors and producers would try to move from A to B. Asset values would fall in A and rise in B. This is in essence what happens on a global scale amongst nations.

*Arthur B. Laffer and James C. Turney, "Trade Policy and the U.S. Economy," Laffer Associates, March 24, 1982.

Going back to our specific example, let's keep the time period very short but let's let this country exist in a sea of nations. If this were the only country to cut tax rates, not only would domestic residents want more of the now higher after-tax yielding assets, but foreigners would want more as well. Unfortunately, foreigners who want to hold more of the higher yielding assets would have to find a way to convince the current owners of those assets to sell them, or they would have to pick up some of the assets they own located in their countries and move those assets over the border to the lower tax rate country. While this example is highly simplified, it does contain the essence of what actually happens. People do move assets from one country to another in order to take advantage of lower tax rates.

In the very short run, before people can save or invest their income, the issue of who owns what is not simple. For example, within one economy every seller needs a buyer and every buyer needs a seller. The question then arises: what does the buyer give the seller to induce the seller to sell the income-earning asset? Within a single economy, when we talk about an increase in the price of an asset we're talking about an increase in the purchasing power price of an asset. We call this the money price. The word money as used here is a claim on goods.

Once we move to a multi-country setting, the issue gets a little more complicated. For our purposes the key exchange is between holders of assets in the tax cut country and holders of assets in countries where taxes are not cut. Once the tax cut has taken place, holders of assets in the tax cut country would require more non-tax cut country assets for every higher yielding asset. Holders of assets in the non-tax cut country would be willing to pay more because of the higher after-tax returns attributable to assets in the tax cut country. This, in essence, is an increase in the terms-of-trade of the tax cut country, and is reflected in an increase in its real exchange rate. It's all here.

The ever-expanding migration of capital from one country to another has made the world a smaller place to live.

The costs of moving assets across country borders will determine how much asset prices in the tax cut country rise, how much after-tax yields rise, and the extent of the migration of assets into the now-lower tax country. We have now entered the global realm. The migration of assets into the lower tax country is called a trade deficit/capital surplus. Obviously, on the other side of the transaction the migration of assets out of foreign countries constitutes a trade surplus/capital deficit for those countries. The lower the cost of moving assets across national borders, the greater will be the trade deficit/capital surplus and the less the prices of assets need rise in the tax cut country. Therefore, even in the very short run a tax cut will lead to 1) a rise in the prices of domestic assets relative to the prices of those same assets abroad, and 2) an inflow of assets from abroad.

The inflow of assets from abroad is the trade deficit/capital surplus, and the relative rise in the price of assets is an increase in the terms-of-trade. It's as simple as that, and there's nothing more to it.

To bring the two views of the trade deficit back into stark relief—one where trade deficits are a consequence of more attractive investment opportunities and the other where the trade deficit is a result of excessive domestic spending—you can tell whether the trade deficit is a result of squanderous excess (over-consumption) or good economics (exceptional returns on capital) by looking at the terms-of-trade. As a reminder, the terms-of-trade of a country is the relative price of that country's goods versus the prices of goods in other countries, and is reflected in the real (inflation-adjusted) exchange rate between two countries. The terms-of-trade is a price while the trade deficit is a quantity.

In normal supply and demand analysis, if an increase in quantity is due to an increase in demand then the price should rise. If the increase in quantity is due to an increase in supply then the price should fall. In a like vein, if the trade deficit were to result from over-consumption, then the country's terms-of-trade should fall. If, on the other hand, the trade deficit were the consequence of great investment opportunities, then the terms-of-trade should rise. Distinguishing between capital-driven trade deficits and consumption-driven trade deficits is pretty clear.

The U.S. Experience

When the U.S. was cutting taxes in the late 1970s and early 1980s I made my point this way:

In an integrated world economy, international capital flows equalize risk-adjusted after-tax rates of return across countries. By changing their tax policies, governments temporarily can alter after-tax rates of return within their boundaries and, thereby, influence capital inflows.

For example, a reduction in tax rates in the United States raises after-tax rates of return in this country relative to those available in other lands. Attracted by the higher after-tax returns, foreign and domestic investors will shift their investments to the U.S., and the U.S. will experience a capital inflow. Under a system of flexible exchange rates, the trade account mirrors the capital account. Thus, increased capital inflows imply a deteriorating trade balance. The inflow of capital will continue until after-tax rates of return available in the U.S. are brought back in line with returns available elsewhere. As the capital inflows subside, the trade deficit diminishes.

*By cutting tax rates, deregulating business, adopting an anti-inflationary monetary policy, and implementing other supply-side policies, the Reagan administration has improved the prospects for real economic growth in this country. At the same time, the after-tax rewards for investing in the United States have risen relative to those available in other countries. This has attracted capital from other countries resulting in the deterioration of the trade account.***

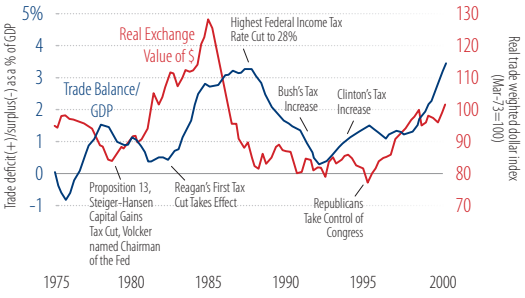
Once we move out of the short-run time frame into a longer-term dynamic perspective, other things start to adjust. For example,

** Truman A. Clark and Arthur B. Laffer, "The U.S. Trade Deficit: A Cause For Cheer, Not Alarm," Laffer Associates, September 30, 1987.

higher after-tax returns on assets resulting from a tax cut encourage people to save more in order to acquire more higher-yielding assets. Remember, people don't save to pay taxes. They also don't save to go bankrupt. People save to make an after-tax rate of return on their savings. Over time, as people save and accumulate assets, the initial rise in the relative price of assets starts to recede. In due course, a simple tax rate cut should lead to an initial trade deficit/capital surplus and an increase in the terms-of-trade. But, as time progresses, higher domestic savings and more accumulated assets should reverse both the trade deficit/capital surplus and the rise in the terms-of-trade. For a once-and-for-all tax cut the system will return to its original state. Of course, a series of tax cuts and other pro-growth measures could keep the effect going for eons. In fact, as I mentioned earlier, in our own history we have a vivid example of how long a country can run trade deficits.

From 1640 until 1870 the U.S. ran trade deficits/capital surpluses non-stop. That's a period of 230 years where the U.S. built its production base and became the premier economic force on Planet Earth with foreign capital. That's a long time during which the returns on capital remained relatively high. Investment opportunities exceeded the domestic economy's aggregate savings; stated differently, during this period more goods and services (consumption) and capital goods (investment) were acquired than were produced. The difference was net imports from the rest of the world, as foreign suppliers provided the excess goods, services, and capital goods in exchange for future claims against the output of the U.S. economy. By the way, wages were also very high and people migrated to America as well. Our international balance of payments

Figure 2: U.S. Trade Deficit(+)/Surplus(-) as a Percentage of GDP vs. Real Trade-Weighted Exchange Value of the Dollar* (through 2Q2000, trade in goods and services)



accounts, however, don't have a category for a people surplus.

Conversely, in the 1950s, investment opportunities in the rebuilding of the countries of Western Europe and Japan exceeded those countries' savings and production relative to their consumption. During this time the U.S. ran trade surpluses and invested heavily in these nations. We provided the rest of the world with the real resources to increase their output, employment, and productivity.

The more recent period of U.S. trade deficits/capital surpluses is equally illustrative of the mobility of capital on a global scale and how relative prices are impacted. Up until 1978, the U.S. had an anti-business/anti-growth posture. The highest marginal federal tax rate on unearned income was 70%, not counting state and local taxes. We

*** As measured by the Board of Governors of the Federal Reserve's "Real Major Currencies" index, price adjusted. It represents the value of the dollar vs. a trade-weighted currency basket of 16 currencies. The countries (and their weights in the index): Canada (29.85%), Japan (24.03%), Germany (10.79%), U.K. (8.24%), France (5.55%), Italy (4.43%), Switzerland (3.19%), Netherlands (2.69%), Belgium/Luxembourg (2.58%), Australia (2.40%), Sweden (1.63%), Ireland (1.61%), Spain (1.47%), Austria (0.68%), Finland (0.61%) and Portugal (0.25%). The Belgian/Luxembourg franc is treated as one currency.

had domestic price controls on oil and natural gas, an excess profits tax, high tariffs, and a capital gains tax structure to make your teeth chatter. Inflation was out of control and the dollar was in free fall. All in all, the returns on capital were very low, if not negative.

Starting in 1978, everything began to change. In 1978, we had the Steiger-Hansen capital gains tax cut, Paul Volcker took over as Chairman of the Federal Reserve Board, and California passed Proposition 13. And, from then on things only got better. The returns on capital started to rise.

In 1981, Ronald Reagan became president and all hell broke loose. From 1981 on, the highest marginal federal income tax rate fell from 70% to 28%, the capital gains tax rate went from 50% to 20%, inflation fell from double digits to 2.5%, tariffs were cut dramatically, deregulation was ubiquitous, government's share of total spending fell, etc. America moved from an anti-growth, redistributionist, protectionist disaster, to the America of today.

Ronald Reagan's swearing in began an unprecedented period of economic growth.

Complications to this basic story arise all over the place, but they don't change the basic story one iota: tax cuts and other pro-growth policies invariably yield trade deficits in the tax cut country and higher relative asset prices. ◆

Thinking Economically

About the Author

Arthur B. Laffer is the founder and chairman of Laffer Associates, an economic research and consulting firm that provides global investment-research services to institutional asset managers, pension funds, financial institutions, and corporations. Since its inception in 1979, the firm's research has focused on the interconnecting macroeconomic, political, and demographic changes affecting global financial markets.

Dr. Laffer has been widely acknowledged for his economic achievements. His economic acumen and influence in triggering a world-wide tax-cutting movement in the 1980s have earned him the distinction as the "Father of Supply-Side Economics." He was also noted in *TIME's* 1999 cover story on the "Century's Greatest Minds" for inventing the Laffer Curve, which it deemed one of "a few of the advances that powered this extraordinary century." His creation of the Laffer Curve was deemed a "memorable event" in financial history by the *Institutional Investor* in its July 1992 Silver Anniversary issue, "The Heroes, Villains, Triumphs, Failures and Other Memorable Events."

Dr. Laffer was a member of President Reagan's Economic Policy Advisory Board for both of his two terms (1981-1989).

Thinking Economically

Texas Public Policy
FOUNDATION

The Texas Public Policy Foundation is a 501(c)3 non-profit, non-partisan research institute guided by the core principles of individual liberty, personal responsibility, private property rights, free markets, and limited government.

The Foundation's mission is to improve Texas by generating academically sound research and data on state issues, and by recommending the findings to opinion leaders, policymakers, the media, and general public.

Funded by hundreds of individuals, foundations, and corporations, the Foundation does not accept government funds or contributions to influence the outcomes of its research.

The public is demanding a different direction for their government, and the Texas Public Policy Foundation is providing the ideas that enable policymakers to chart that new course.

900 Congress Ave., Ste. 400
Austin, Texas 78701
Phone 512.472.2700, Fax 512.472.2728
info@TexasPolicy.com
TEXASPOLICY.COM