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Good on Taxes, Bad on Trade

by David R. Henderson
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Glenn Hubbard and Peter Navarro. Seeds of Destruction. FT Press. 266 Pages. $26.99.

With all the economic uncertainty, with the unemployment rate close to double digits, with the financial and housing crises not yet resolved, and with Congress having passed a health care law that restructures over one-seventh of the economy, we have been due for a book by seasoned economists that looks at the big picture and proposes solutions. Is Seeds of Destruction, by economists Glenn Hubbard and Peter Navarro, that book? Some economists and economic journalists whose work I respect — my Hoover colleagues John Cogan and John B. Taylor, and economics writer Amity Shlaes, for example — say yes. But I disagree with them.

Seeds of Destruction could have been that book. For one, it deals with most of the important economic issues — health care, tax policy, Social Security, and trade policy — and has some good insights into and policy proposals for some of them, especially tax policy. And Hubbard, having been President George W. Bush's first chairman of the Council of Economic Advisers, and deservedly so, is certainly in a position to have knowledge, both wide and deep, of the issues. But Seeds of Destruction sometimes just gets the facts plain wrong, and the authors' analysis is, on occasion, also outright wrong. Moreover, the policy they propose on oil would prop up the monopoly power of the Organization of Petroleum Exporting Countries (opec), and yet they write not a word about this downside.

Start with the positives. The strongest chapter, by far, is the one titled, "Why You Can't Stimulate Your Way to Prosperity." This case against using increases in government spending as a countercyclical policy to end a recession is a nice blend of economic and political analysis. Hubbard and Navarro point out what has long been an argument against such policies: the often long lag between when a law increases spending and when the spending actually occurs. But they go further and draw on some more-recent research by Harvard economists Alberto Alesina and Silvia Ardagna that has justifiably received much attention. Alesina and Ardagna, examining fiscal stimulus in 21 countries, found that the most successful ones relied "almost entirely on cuts in business and income taxes" and that the least successful relied on increased government spending.

Moreover, note Hubbard and Navarro, Christina Romer, Obama's first chair of the Council of Economic Advisers, and her husband, David Romer, an economist at uc Berkeley, found that hiking taxes, as Obama has now done by letting the Bush tax cuts expire, leads to a strong negative effect on gross domestic product. The authors also point out, as did Obama adviser Lawrence Summers, that any increase in government spending should be targeted and temporary. They write that, instead, "the Democrats used their majorities in both houses of Congress to pass pet projects and programs that were only tangentially related to the stimulus" and these programs were designed to be permanent. Even Obama's own budget director, Peter Orszag, they note, stated that grants for alternate energy sources "are totally impractical for countercyclical [anti-recession] policy." But in January 2009, when the newly sworn-in President Obama was "at the height of his popularity and power," he inexcusably outsourced the stimulus bill to Senate Majority Leader Harry Reid and House Speaker Nancy Pelosi. No wonder Romer, Summers, and Orszag are leaving or have left the sinking Obama ship.

The chapter on tax policy is also one of the book's strengths. Hubbard and Navarro lay out just how destructive the federal tax system is or soon will be. They point out that by letting the Bush tax cuts expire, President Obama and the U.S. Congress are letting the long-term capital gains tax rate rise from fifteen percent to twenty percent and the top rate on dividends rise from fifteen percent to a whopping 39.6 percent. Moreover, they point out, the new health care law will impose a further 3.8-percentage-point increase in the tax rate on so-called "unearned income," the term used for income from realized capital gains, interest, and dividends. That means that the top rate on capital gains will rise from fifteen percent to 23.8 percent and on dividend income from fifteen percent to 43.4 percent, almost tripling. Meanwhile, the United States has one of the highest tax rates on corporate income in the world. High corporate tax rates discourage capital formation and, therefore, people's real wages. The authors cite a finding in a study by the Organization for Economic Cooperation and Development that corporate taxes harm economic growth more than other taxes. They write, "America's current tax system is a train wreck when it comes to capital formation, job creation, and long-term economic growth."

To solve this problem, Hubbard and Navarro have two main proposals. First, they would replace the individual income tax with a "progressive consumption tax." Income would be taxed with a graduated rate structure, just as it is now, but all forms of capital income earned by individuals —

interest, dividends, and capital gains — would be exempt. On the business side, they propose retaining the tax on corporate income but allowing all capital investment to be deducted as an expense rather than, as is done now, being depreciated over time. They also propose eliminating the current deduction for business payments of interest in order to undo the bias in the current tax code in favor of debt and against equity. Currently, there's an incentive for corporations to favor debt over equity because they can deduct the interest to bondholders but can't deduct the dividends paid out to shareholders. Hubbard and Navarro point out that these proposals, taken together, would eliminate the double taxation of capital income. They could have pointed out that these proposals would also eliminate the triple taxation of capital income. Why triple? Because individual income that is not consumed is currently taxed when earned (strike one). Then, when it is invested and earns interest and dividends, it is taxed (strike two.) And then, when the asset is sold, the capital gain is taxed (strike three).

A third strength is their section on Social Security, in which they point out that one of the main problems with the program is wage indexing. That is, benefit payments for retirees are linked to wages rather than to prices. The fact that real wages rise over long periods means that a person with average wages who retired in 2005 got an annual benefit (in 2005 dollars) of about $14,000, whereas an average-wage person retiring in 2050 would get over $20,000 (in 2005 dollars.) President Carter introduced wage indexing in 1977. Hubbard and Navarro note that Democratic economist Peter Diamond, one of the three economists who will receive the Nobel Prize in economics in December, in a 1977 letter to the New York Times, criticized wage indexing. It would, wrote Diamond and his coauthors, call for "a much larger growth in benefits for future retirees at a time when the country may not be able to afford it." Of course, their letter was prescient. Hubbard and Navarro propose indexing benefits to prices so that retirees are protected from inflation but are not granted higher and higher real benefits. This one change, they note, would close a whopping 70 percent of the projected Social Security shortfall. They also propose immediately raising the age for full benefits to 67 for anyone born after 1954, then raising the age by two months a year until it reaches 70, and, after that, raising the age by one month every other year to keep it in line with rising life expectancy.

So what's not to like about the book? Most of the worst parts are in the sections on international trade. Let's start with what economists know about international trade. We know that, by standard measures of economic well-being, a country is better off having free trade than not having it. We can go further. We can show that even if the government of another country restricts imports or foreign investment, we are better off if our government does not retaliate with its own restrictions on trade. The other government hurts its own consumers by restricting imports and, if our government retaliates, it hurts not only the other country's exporters, but also our country's consumers. Ronald Reagan, although he did not always practice free trade, understood this argument and, in a 1982 speech against protectionism, used a beautiful analogy to make the point. Imagine you and someone else are in a lifeboat in the middle of the ocean. If the other person foolishly shoots a hole in the boat, so that water comes pouring in, are you better off, asked Reagan, if you shoot a second hole in the boat?

Yet this clarity seems to have eluded Hubbard and Navarro. They write, "Free trade between two nations will never lead to stronger economic growth for both countries unless both play by the rules." That's simply false. It's true that if both play by the rules, the average person in each country will be better off than if one side doesn't play by the rules. But we can have — and, indeed, have had — strong economic growth in this country even if some other countries' governments break the rules.

The chief villain in the authors' account is the Chinese government. What are its sins? They include "illegal export subsidies, an undervalued currency, counterfeiting and piracy, and lax environmental and health and safety standards." Consider each charge in turn.

First, while it's true that illegal export subsidies hurt our competing producers of the exported goods, those same subsidies help our consumers by making the product artificially cheap. Whether they are a net loss or gain to the United States depends on whether the losses to our producers exceed or are less than the gain to our consumers. If the United States exports a major share of the world's production of a good, as it does with airplanes, a Chinese export subsidy for airplanes would probably hurt U.S. producers more than it helps U.S. consumers. But Hubbard and Navarro don't even consider this tradeoff. For them, illegal export subsidies are bad per se. Of course, there is one group for whom such subsidies clearly are bad, but this group gets no attention from the authors: That group is Chinese taxpayers.

Second, an undervalued currency, while it causes Chinese consumers to pay too much for imports and earn too little on exports, is a clear-cut boon to the U.S. economy. I feel for the hapless Chinese who have to pay for this, but if a government offers us lower prices, we shouldn't kid ourselves that these lower prices make us worse off.

Third, the authors' point about counterfeiting and piracy is well taken. This is bad and the U.S. government, to the extent that it pressures the Chinese government to play by the rules, should focus on this issue.

Fourth, Hubbard and Navarro argue that the Chinese government's environmental and health and safety standards are "far below international norms." They never specify what these norms are. China is a poor country. Yes, it's now the second-largest economy in the world, but that large gdp, divided by over 1.3 billion people, gives China a gdp per capita that is less than one-sixth of ours. Environmental quality and safety are what economists call "normal goods" — that is, goods that people demand more of as their real income rises. So it's not surprising that China's standards are currently well below ours. Moreover, to the extent that they are "too low," whatever that means, this hurts the Chinese people but helps American consumers. I suspect, though, that most Chinese want such low standards so that their wealth will grow and their children can have more wealth, more safety, and a better environment.

"How can the United States reduce its chronic trade imbalances with China — its largest trading partner?" ask Hubbard and Navarro. But their premise is wrong. The United States' largest trading partner is Canada, with China a fairly distant second. They state that "in a world of free trade characterized by floating exchange rates, the U.S.-China trade imbalance could never persist." That's incorrect, also. Nothing in the theory of international trade says that people in country A should buy the same value of imports from country B that people in country A sell as exports to people in country B. Just as I have a "trade imbalance" with the Hoover Institution — I sell much more to Hoover than I buy from it — so the same applies to trade between various countries.

The authors claim that a reduced demand for our exports costs the U.S. economy jobs. No, it doesn't. If a foreign government restricts our exports to its own consumers, that costs jobs in our exporting industry, but those people find work in other industries. The long-run issue with jobs is not job loss but job switching. People have jobs in different industries, but they still have jobs.

The authors state that America will increasingly depend on oil and natural gas from "countries that have historically been our enemies or . . . countries that are prone to frequent supply disruptions because of political instability." They're more certain of this than I am. But they may be right. So what's the problem with that dependence and what's their solution?

They write: "Oil's brake on net exports is an obvious problem." No, it's not. As international-trade economists have understood since Adam Smith, it's better to buy cheaply from people in another country than expensively from high-cost producers in our own country. Incidentally, they write that Adam Smith and David Ricardo were contemporaries. No, they weren't. When Adam Smith died in 1790 at age 67, Ricardo was eighteen years old.

Another problem, state Hubbard and Navarro, is that America's heavy oil dependence makes our economy far more vulnerable to slower growth and recessions triggered by sudden price increases. But because oil is traded in a world market, we are vulnerable to price increases whether we import all or none of our oil. So whether we produce all or none of the oil we use, an oil price increase hurts our consumers the same amount. To be sure, if we imported less oil and produced more domestically, a price increase would help our producers. But how would we put ourselves in the position of having more production? By guaranteeing a higher price to domestic producers. By insisting on higher-cost domestic production, we would avoid the possibility of more-expensive oil when prices spike for the certainty of more-expensive oil all the time.

And the policy Hubbard and Navarro propose would make oil more expensive, for one reason they recognize and one they don't. They want the U.S. government to set a price floor on oil by having a variable import fee. So, for example, if the world price of oil is $80 a barrel and the price floor is $100, the import fee would be $20. They are vague about the desirable level for the price floor and entrust it to "the White House, in conjunction with the U.S. Congress and the Department of Energy." Whenever the world oil price fell below this floor, we consumers would lose out because we would still have to pay the floor price. They recognize that fact, but they like it because it would give more certainty to producers of competing fuels.

What Hubbard and Navarro do not recognize is that their very proposal would give increased market power to opec, making world prices higher than otherwise. There is a scholarly literature on this in the Energy Journal, to which I have contributed, but about which they seem unaware. A price floor on oil sold to the United States, a country that uses about one quarter of the world's oil, would make U.S. consumers artificially insensitive to any world price of oil below the price floor.

Currently, opec has to trade off the higher revenue per barrel of a price increase with the reduced number of barrels sold. But opec officials would quickly figure out that if they reduced the price of oil below the U.S. price floor, there would be no such tradeoff in the U.S. market. No matter how low opec cut the price below the floor, the increase in barrels demanded from the United States would be zero because the U.S. government would not allow its consumers to buy at that price. If, for example, the price floor were set at Hubbard's and Navarro's hypothetical $100 per barrel, and opec considered cutting the price from $100 to $40, it would not sell a single barrel more in a market that accounts for one quarter of the world market. The good news is that U.S. consumers don't use all the oil in the world. If they did, then opec would set the price at that price floor. The bad news is that because we do consume so much oil, opec would be less likely to cut price. Thus, ironically, the authors' proposal would transfer wealth from world oil consumers to those same countries that they regard as our enemies.

With the stakes in the economic debate so high, we need a book that lays out just how we can get back our freedom and, with it, increased economic growth. Unfortunately, Seeds of Destruction, while it sometimes hits the nail on the head, misses too often.

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