

# ECONOMIC DIRECTIONS

A Publication of Saint Vincent College's Alex G. McKenna Economic Education Series

Saint Vincent College, Center for Economic Policy Education, Latrobe, Pennsylvania

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## THE MOST INIQUITOUS TAX

*"What U.S. industry needs is better domestic policy. The cost of capital is high in the U.S.; that handicaps U.S. industry. The cure for that is an improved domestic tax structure with less frequent changes, a more stable monetary policy, and less government spending."*

*(The following is a transcript of a lecture delivered by Dr. Yale Brozen, Professor of Economics Emeritus at the University of Chicago and Adjunct Scholar of the American Enterprise Institute, at Saint Vincent College, Latrobe, Pennsylvania, on October 16, 1991. The lecture was the first presentation in the 1991-1992 Alex G. McKenna Economic Education Series of lectures on privatization, taxation, and government deregulation.)*

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Almost all taxes are iniquitous. Choosing the *most* iniquitous makes it necessary to examine a wide array. The sheer number of candidates forces a choice that is almost arbitrary because of the numerous categories from which one must be selected.

First let me tell you what I mean by iniquitous. Most taxes impose a substantial *non-revenue yielding burden*. For example, it costs the private economy approximately \$1.56 to yield a dollar of revenue to the federal government. The reason the cost exceeds the governmentally collected dollar by 56 cents — the reason for this substantial non-revenue yielding burden — lies in the differential impact of taxation.

Some uses of our resources bear a heavier tax burden than others. If I earn income writing a pamphlet, that income is taxed. Where I live, every \$1.50 I earn

at the margin has federal and state taxes imposed amounting to 50 cents. After taxes, I have one dollar left out of \$1.50 of marginal cash income.

Suppose I decide to do my own gardening instead of writing pamphlets. That being the case, I dispense with my lawn service. Doing that, I find that I save \$1.10 for every \$1.50 I no longer earn by my writing. That may seem like a poor exchange, but no tax is levied on the \$1.10 saved by doing my own gardening. It never appears as money income.

Using my efforts less productively makes me better off. I choose to apply my efforts where I can earn only \$1.10 instead of doing more productive work where I could earn \$1.50. The \$1.50 is reduced to only \$1.00 by taxation. That is less than the \$1.10 I earn by less productive effort. Fully measured national product is reduced by 40 cents.

The assignment of labor and capital to less productive uses because of heavier taxation on more productive applications of our scarce resources reduces national income. This loss caused by the differential impact of a tax is a measure of the iniquity of the tax. It is not a complete measure, but it is a beginning.

I have selected taxes on imports as our most iniquitous tax. (Quotas on imports - currently referred to as VRAs or voluntary restraint agreements - are simply an infinite tariff on goods exceeding the quota. Therefore, I lump these together with tariffs as part of the group I call import taxes.)

What makes this tax more iniquitous than income, property, excise, fuel, sales, and license taxes? Import taxes cause three categories of loss. First, they force resources out of more productive into less productive uses. Second, they reduce the rate of capital formation. This slows the rate of productivity growth. Third, the attempt to persuade the public and Congress to enact restraints on imports itself consumes resources with no gain to the economy. What the benefitted interests gain from an import restraint is more than offset by the loss to others. The lobbying of rent-seekers is a negative-sum game.

## Tariffs and Resource Reallocation

The enactment of import taxes deprives foreigners of the opportunity to earn dollars which they could use to buy our



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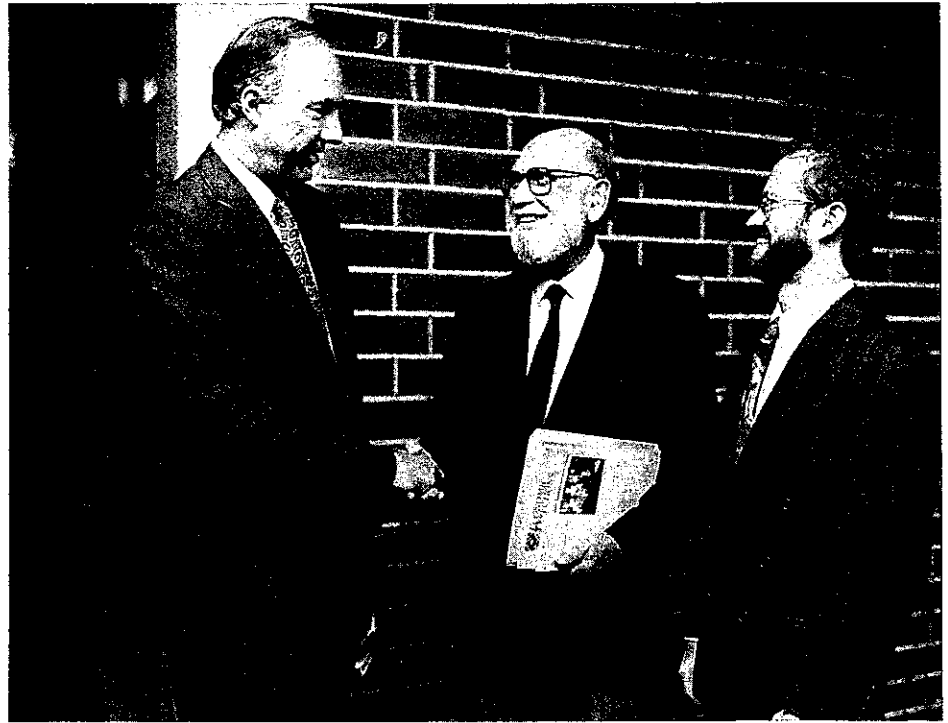
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WELCOME — Dr. Brozen is greeted at Saint Vincent College by Mr. James L. Murdy (left), a member of the Saint Vincent Board of Directors, and Dr. Gary M. Quinlivan (right), who directs the lecture series. Mr. Murdy, who also introduced the lecture, is Senior Vice President Finance and Chief Financial Officer for Allegheny Ludlum Corporation.

products. They earn dollars by selling us goods in which we are *relatively* less productive. They spend these dollars on goods which we produce relatively more efficiently. Reducing our purchases from foreigners by imposing tariffs reduces the output of our more efficient industries because of reduced sales to foreigners. Resources no longer find employment in our most productive uses when the supply of dollars to foreigners is reduced by restricting imports.

If we no longer import the goods in which we are relatively less efficient, we will increase domestic output in this line of commerce to satisfy domestic demand. Resources no longer employed in our more productive uses will move (directly or indirectly through a chain of substitutions) into our relatively less efficient industries. It may seem paradoxical, but the fact is that the domestic industries clamoring for protection from imports are really trying to gain protection from the competition of our export industries for labor and capital.

The textile, shoe, sugar, and lumber industries pay low wage rates in spite of the protection afforded them by tariffs and quotas. The aircraft and computer industries export and overcome

shipping costs to foreign destinations and foreign tariffs. Nevertheless, they compete for the labor of lower paying industries by offering higher wage rates. Union leaders in the textile, shoe, and lumber industries clamor for tariffs because they compete for members with the unions in export industries. They do not want any expansion of export industries — they do not want foreigners earning more dollars with which to buy more of our exports — because they would lose membership to the unions in the export industries.

Tariffs force the transfer of resources from more to less productive uses. That is a main cause of their non-revenue yielding burden. The higher tariffs go, the less is collected. Thus the non-revenue yielding burden per dollar collected would be greater. An almost completely protective tariff reduces collections to near zero and causes a near infinite non-revenue yielding burden per tax dollar collected. You can hardly get more iniquitous than that. Yet the tariff *is* more iniquitous than that.

## Capital and Productivity

The United States produces greater output per worker hour and pays higher wage rates than almost any other area of the world. Two factors account for

*"Our trade deficit was and is a blessing, not a curse. During the nineteenth century, it financed the growth of the U.S. economy."*

most of the difference. One is that the U.S. is a very large free trade area with low cost transportation. That enables most industries and firms to take advantage of economies of scale. The second factor enabling us to be very productive is the large amount of capital used per worker. Every U.S. worker has a large number of "iron coolies" to assist him or her in this effort.

The last two decades have seen a slow down in our growth of output per worker hour. The decrease in productivity growth is largely a consequence of a fall in the savings rate and, as a result, a slower rate of capital accumulation. That, in turn, has produced a slowing in the rate of increase in real wage rates.

Two decades ago the *personal* saving rate ran around 9 percent. That has dropped by 50%. The *national* saving rate ran well in excess of 9 percent two decades ago. With the rise in government deficits which consume a large part of our national savings, the net national savings rate and the capital formation rate have dropped drastically.

The decline in productivity growth has paralleled the drop in national saving. Productivity growth has fallen from 3.2% per year to less than 1 percent. That results in real wage rates doubling only every century instead of every 20 years.

But what do the rate of capital formation and productivity growth have to do with tariffs? Have I gone off on a side track?

To explain the link between import taxes and the rate of growth of productivity and real wage rates, we need to know something about the role of the international balance of payments in our economy. When we talk about the trade balance, we are referring to the dif-

ference between what we pay foreigners for goods we buy from them and what they pay us for goods we sell to them. Last year we bought \$500 billion worth of goods from foreigners. They spent \$400 billion buying from us.

Foreigners acquired \$100 billion for goods they shipped to us that they did not spend for our goods shipped to them last year. What did they do with that \$100 billion? They certainly did not use that \$100 billion as wallpaper. It's not that decorative. Nor did they stick it under their mattresses. They did not pay workers with dollars. Almost all workers except Soviets prefer being paid in local currencies, whether they be pounds, francs, or lira, that they can spend in their local grocery stores.

What was done with that \$100 billion was that it was invested in the United States. It helped to finance U.S. capital formation. Gross capital formation in this country last year amounted to over \$750 billion. Most of that new plant and equipment and homes replaced machinery and buildings that wore out or were demolished by hurricanes, tornadoes, fires, and termites. Of the \$750 billion of new capital goods put in place in the U.S. in 1990, \$100 billion was paid for by foreigners. If they had not earned \$100 billion more than they spent for our exports, only \$650 billion of gross private domestic investment could have been financed. Capital goods industries would have suffered a 13 percent drop in employment assuming no adjustment of wage rates to prevent such a drop.

Productivity would have dropped even more than the one-half percent drop it did suffer.

## The Balance of Payments

If we raise our tariffs and further tighten import quotas, we could reduce our imports. Although this would reduce exports as well, there would be some reduction of the difference between imports and exports. But that would decrease the inflow of capital and restrain the rise in productivity. That is a second source of iniquity flowing from import taxes.

We need to dispel the notion that a negative balance of payments is bad for us. That is a notion which confuses public policy and misdirects our attention.

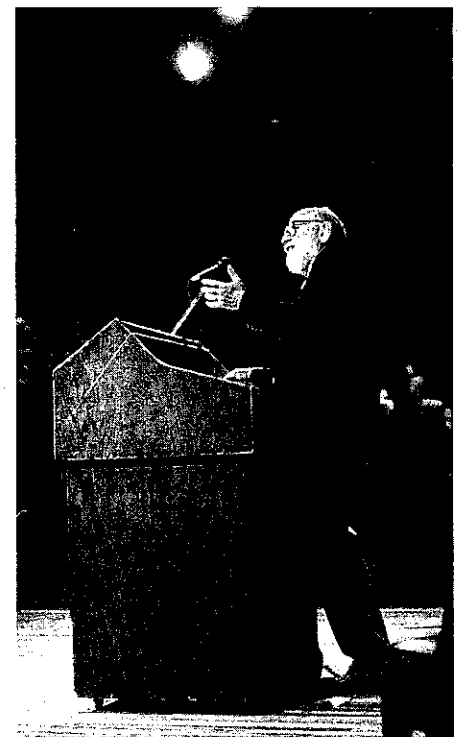
Our trade deficit was and is a blessing,

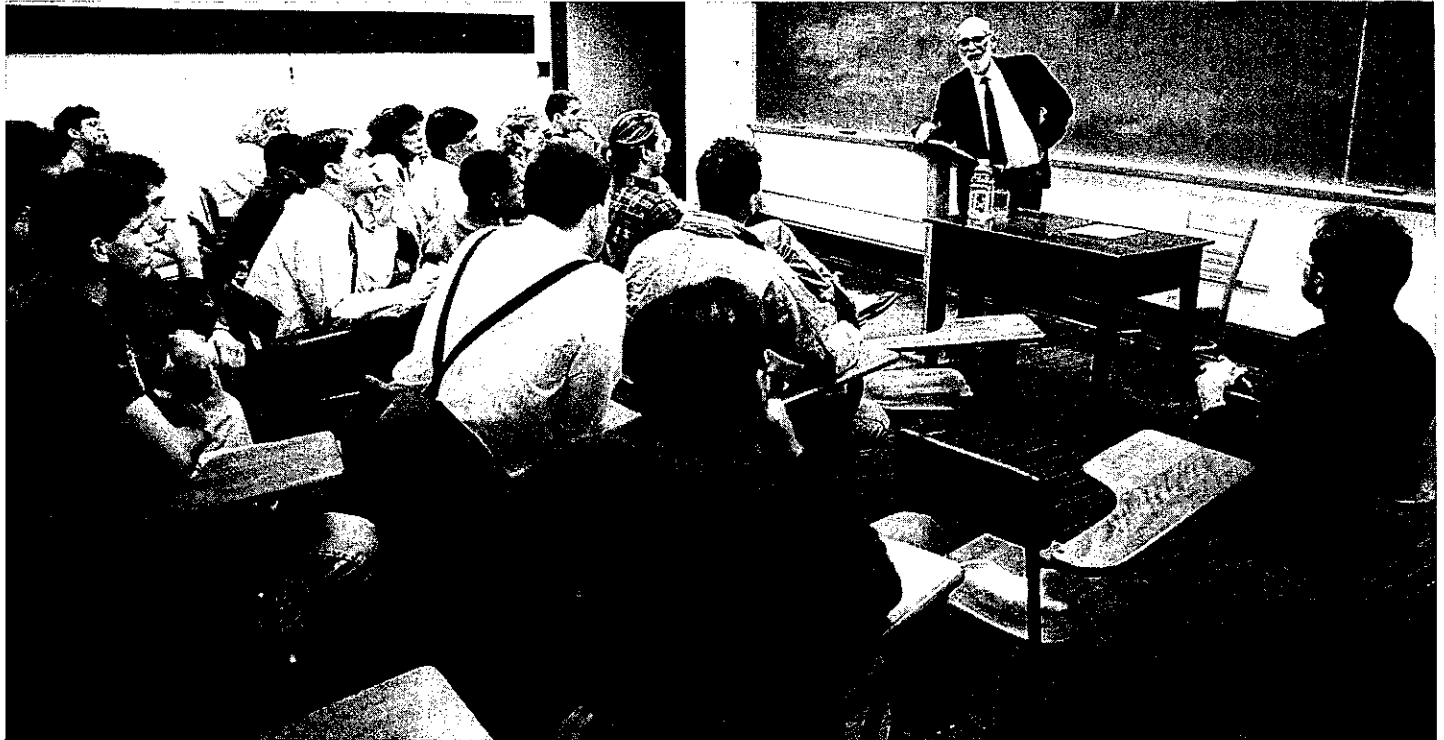
not a curse. During the nineteenth century, it financed the growth of the U.S. economy. English capital built railroads. The Northwestern Railroad out of Chicago going west still runs its trains on the left side of its right of way. Japanese capital in the last decade has financed new plants in Michigan, Pennsylvania, Illinois, Ohio, Tennessee, and Kentucky. Were it not for Dutch and British capital, there would be fewer synthetic fiber and paper mills in the U.S. (and lower real wage rates).

Despite what foreign investment has done for the U.S., newspaper columnists and politicians tell us that the country is deindustrializing as a consequence of the trade deficit. They say that we are exporting jobs by importing goods. They go on to warn us that manufacturing is moving abroad, that factories are disappearing, that we are becoming a debtor nation. Congress tells us that we must enact protectionist legislation to prevent these dire consequences of a "negative" balance of trade. Jobs are disappearing, it is said, because the foreigners are taking over our manufacturing.

## Are We Deindustrializing?

Instead of listening to all this rhetoric, let's look at what is actually happening to manufacturing output and employment in the United States. Are they actually decreasing?





**DIRECTION** — Dr. Brozen had an opportunity to meet informally with Saint Vincent College Economics and Business Administration students prior to the lecture to share some insights on career planning.

We set a new record for total manufactured production in the United States in 1979. The output of U.S. manufacturing industry in 1979 was *double* what it was in 1963.

In 1980 and in 1981-82 we had back to back recessions. Manufactured output fell as it always does in recessions. It recovered in 1983 and set another new record in 1984. It has continued to set new records every year since. Manufacturing industry turned out 36 percent more product in 1990 than it did in 1979 when we turned out 100 percent more product than we did in 1963.

The only major industries that have fallen behind this 1979 record are primary metals — mainly iron and steel — petroleum products, and leather. The tobacco products industry has barely kept up and apparel has done little better. But every other industry has done well.

Out of 22 major manufacturing industries, three are producing less than in 1979. The growth in the other 19 far more than offsets the decline in the three. As a result, total manufactured output is up by 36 percent over its 1979 level. It has never been higher than it was in 1990.

As a proportion of the total output of the country, manufacturing contributes

a little less than 22 percent of the total output in prosperous years. The figure has stayed around that level all through the post-war period. It was 21.5 percent in 1948. In 1986, it was 21.9 percent and a little less than 22% in 1990.

Employment in manufacturing rose in the post-war years from 14 million in 1946 to a peak of over 21 million in 1979. It dropped to 18 million in the 1982 recession. Its recovery since 1982 has not brought it back to its 1979 peak, but that is a spurious indicator of manufacturing's health.

Manufacturing employment did not return to its 1979 level in 1990 according to census records in spite of record output. This occurred because many of the workers used by manufacturing industry formerly classified in manufacturing are now classified in the service industries. The steel mills in northern Indiana and southeast Chicago formerly used their own crews to maintain their continuous casters. They now hire an outside maintenance service to maintain their casters. The employees of maintenance companies are classified by the census in the service industry.

Also, the trucking industry was partially deregulated in 1980. With deregulation, interstate common carrier trucking firms became competitive and truck rates fell.

It is now cheaper for manufacturers to hire common carrier truckers for much of their work than to maintain large trucking operations of their own. The truck drivers who used to be classified as manufacturers' employees are now classified in the trucking industry. It, too, is a service industry.

Prior to 1980, the budgets of factories usually has less than 1 percent devoted to outside administrative and maintenance services. Those budgets now commonly devote 5 to 10 percent of their outlays to outside providers of these services. These are also classified in the service industry.

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## About the Series

*The Alex G. McKenna Economic Education Series is presented by the Saint Vincent College Center for Economic Policy Education at Saint Vincent College. These periodic lectures are open to the general public and their purpose is to explore the role of free markets in solving many of the social problems confronting the United States and the world today. Dr. Gary M. Quinlivan, associate professor of economics at Saint Vincent, directs the series.*

*The Alex G. McKenna Economic Education Series is made possible by a grant from the Philip M. McKenna Foundation Inc. of Latrobe, Pennsylvania.*

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*"Tariffs force the transfer of resources from more to less productive uses."*

The employment created by the manufacturing industries is much larger today relative to what the Bureau of Census reports that it was in 1979 when record manufacturing employment was reported. To look only at the recent trend in what Census reports as manufacturing employment gives a false picture of the actual trend in jobs created by this industry.

If we were actually exporting manufacturing jobs abroad, we should expect manufacturing employment in other nations to be growing relative to our own. That, however, is not the case.

From 1960 to 1973, aggregate hours of manufacturing employment (as classified by Census) in the United States grew at a compound annual rate of 1.6 percent per year. Aggregate hours in 10 other major industrial countries (including Japan) grew at only one-fourth that rate — 0.4 percent per year.

From 1973 to 1981, the uptrend in manufacturing employment in the United States was cut in half, averaging

only 0.6 percent per year. The manufacturing employment trend in the 10 other countries did not simply drop. It became a downtrend. Employment in the 10 other countries actually fell 1.7 percent per year. If anyone has a right to complain about a downtrend in manufacturing employment, it is Japan and the 8 leading European countries.

Their manufacturers feel a much greater need for protection than ours do, especially with the drop in exchange rates since February 1985. As things stand, the U.S. is actually exporting chopsticks to Japan — over 2 billion pairs a year. The jobs exported by U.S. manufacturers have not been to other countries. They have been exported to other industries in the United States.

### Would Protecting U.S. Manufacturers Increase Employment?

Enactment of protectionist legislation, presumably to eliminate the trade deficit and the export of jobs, would do more harm to U.S. employment than good. Let us suppose that we cut the imports of steel and autos by \$10 billion using tariffs or quotas. Employees of these two industries earn over \$50,000 a year in wages and fringe benefits. Since the major cost in any industry is the wages and fringes it and its suppliers pay, let us neglect other costs (which are minor) in order to keep the arithmetic of what follows simple.

Let us assume that the \$10 billion no longer spent on foreign goods is now spent on domestic steel and autos. That, if true, will create 200,000 jobs in these industries.

But the foreigners no longer earn \$10 billion to spend on U.S. goods. Export industries will find their sales dropping by \$10 billion. Since average annual pay and fringes in the export industries is a little over \$30,000, the number of jobs in export industries will fall by more than 300,000. Total industrial employment will drop by 100,000 as a consequence of the job loss in export industries exceeding the jobs created in steel and autos.

But, the protectionists protest, the foreigners don't spend all they earn from their U.S. sales on U.S. goods. So won't they simply have a smaller surplus of dollars as a result of our protectionist legislation and continue to buy as much as ever? Won't the only result be a drop in the trade deficit and, therefore, a rise in jobs in protected industries with no drop in export industries?

But what did the foreigners do with their surplus dollars that they did not spend on U.S. products? Why did they not spend all the dollars they earned for U.S. exports?

Some of their surplus dollars were used to repay borrowings and interest on those borrowings. If they had not sold more goods than they bought from the United States, they would have been forced to default on their debts, as they did in the 1930s after the passage of the Smoot-Hawley tariff.

Another reason that foreigners do not use all their surplus dollars to buy goods shipped across our borders is because they use them to buy goods which remain in this country. The Japanese automobile industry, for example, has bought plants in Michigan, Ohio, Pennsylvania, and Tennessee. They did not export these plants but

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Dr. Gary M. Quinlivan, Economics Department, Saint Vincent College, Latrobe, Pennsylvania 15650-2690.



BEARCAT TRIO — Dr. Brozen is shown with Saint Vincent College Economics majors Dennis J. Yanan, C '92 (left), Michael J. Kozy, C '92 (second from right), and James E. McBride, C '92 (far right).

they should be counted as part of the goods that we traded for our imports. But investment in the U.S. by foreigners is not counted in the payment or trade deficit figures.

## Can U.S. Manufacturing Compete?

There has been much talk of the inability of U.S. manufacturers to compete with foreign manufacturers. Special remedies are called for to improve the competitiveness of U.S. manufacturers — remedies ranging from organizing a federally chartered Industrial Bank to provide subsidized capital to protection for declining industries.

If anything, U.S. manufacturers are competing very successfully with foreign industry. In 1970, export sales took 4.6 percent of U.S. manufactured output. In 1985, when dollars reached their highest level in foreign exchange cost making U.S. goods very expensive to foreigners, export sales took 6.2 percent of all U.S. manufactured output. Now that the dollar has grown less expensive to foreigners, sales abroad of U.S. manufacturers are taking an even larger share of U.S. output, reaching 7 percent in the first half of this year.

U.S. industry is competing successfully in foreign markets, including the market for chopsticks in Japan. They are also competing successfully at home. The talk of a need for a level playing field is fatuous and misleading. What U.S. industry needs is better domestic policy. The cost of capital is high in the U.S.; that handicaps U.S. industry. The cure




Freshman Joseph D. Ward, a business management major from Ephrata, Pennsylvania, questions Dr. Brozen after the lecture.

for that is an improved domestic tax structure with less frequent changes, a more stable monetary policy, and less government spending.

## Conclusion

The Federal government has negotiated a free trade agreement with Canada which is to take effect gradually over the next 10 years. The Federal government is also in the process of creating a similar proposal with Mexico to place before Congress. These are steps in a direction which will reduce a set of taxes that are the most iniquitous in the government's revenue armamentarium.

Yet, there is no other set of taxes that is in such demand. Who can imagine a tax that any part of a Congressperson's constituency asks to be levied and to be increased? That the administration flew in the face of such demands in negotiating a free trade pact with Canada is remarkable. That it succeeded in persuading Congress to accept it is astounding.

That the administration is refusing to pander to the rent-seeking lobby in this matter deserves three cheers. I just hope that it didn't have to serve too much pork to persuade Congress to serve the nation's interest. 



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