Discussion Points for Assignment #1 – Question #3

3. Since government surpluses are by definition 100 percent saved, President Bush’s announced tax cut is de facto a plan to lower the American savings rate. If American savings go down, either Americans must invest less or the rest of the world must lend us more. You work for a firm making investment equipment. Your boss wants you to write her a memo on whether the firm should as a result plan for lower future sales, i.e., do you think that the rest of the world will be willing to lend America substantially more than it is now lending?

Start out with an understanding of how the savings rate would go down with the different tax cuts that Bush is proposing:

1. Income tax reduction – this money would go directly into the pockets of consumers. The private savings rate is quite low so a reduction in income taxes would therefore result in significant decreases in savings.
2. Estate tax elimination – even though this money would go mostly to the rich, it is money that is passed from one generation to the next. This money would most likely not be spent as readily as income so although the savings rate would go down, it would only be a marginal decrease.
3. Marriage penalty elimination – this has the same effect as income tax reduction. Money lost here would result in large savings reductions.

Next discuss why the question makes sense – if savings do go down, why must it be that either investment goes down or the trade deficit goes up:

1. In words – investment is directly correlated to the aggregate savings rate (public and private). If savings falls, then we should see a similar decrease in the amount of investment in America. The only way to avoid this decrease is to have foreign monies make up the windfall, i.e., more foreign investment in the country. Having more foreign investment must be compensated by a bigger trade deficit according to the balance of payments.
2. In equations – By national income accounting: \( S-I=(G+TR-TA)+(X-M) \). A fall in TA (tax cuts) must be balanced by a fall in I (lower investment) or a fall in X-M (bigger trade deficit). BOP accounting then says that a bigger trade deficit must be financed by increased foreign lending. This assumes that \( S \) is either constant or only marginally higher as discussed above and that \( G+TR \) is fairly constant (which is a safe assumption).
Now talk about whether the rest of the world would be more or less likely to lend us more money. You can talk about sentiment and trends in the world en masse but you could also break down the lending scenario into different regions:

1. Europe – it seems unlikely that money would start to flow more readily from Europe to America given the current economic situation of both areas:
   a. Europe currently has a faster growth rate.
   b. Stock market in the U.S. is currently falling faster than in Europe.
   c. After a long bout with appreciation, the dollar is beginning to depreciate against the Euro.

2. Japan – it is a far more likely scenario that money will move to the U.S. from Japan:
   a. Japan currently has a negative growth rate making it unattractive for investments.
   b. This decade-long recession is showing no signs of easing any time soon which provides grim prospects for foreign investors in Japan.
   c. Japan currently has near-zero interest rates which makes the U.S. much more attractive to foreign capital.

3. Other general more global points:
   a. Europe and Japan are really the only two regions of the world that matter in this question because that is where all the money is.
   b. Two-thirds of all foreign investment in the world is already brought into the U.S. To get more foreign investment now, either the total amount of money invested must grow or America’s share of the money must increase, neither of which are very likely.

Overall, it unlikely that money will move from Europe to the U.S. and although some money might come in from Japan, there is not much there to begin with. Most likely, the rest of the world in not willing to lend us even more money than they already do so investment in the United States will fall if Bush’s tax cut plan is passed. Consequently, as producers of investment equipment, we should probably plan for lower sales in the near future.

Another effect of the tax cut plan that could be discussed is the risk of causing a run on the dollar. If investment in the United States falls, this may prompt foreigners to start pulling even more money out. That is, not only would lending not increase, but it might even decrease. This would lead to a dollar depreciation which would cause an even greater flight of investment. This spiral could put immense downward pressure on investment and cause it to plummet even more than we are anticipating.
Other points many people discussed:

1. Interest rates – although interest rates do have a significant effect on the economy and on foreign investment, it is important to note that in theory, monetary and fiscal policy are independent on each other. In practice, though, this is most likely not the case so it seems that interest rates could be directly affected by a tax cut. In the most likely scenario, the tax cut would drive inflation, forcing interest rates up. Many people discussed this effect but missed the fact that higher interest rates, while attracting foreign capital, stifle investment.

2. Wealth effect – talking about the wealth effect due to the tax cut is an important point in examining consumption changes but several folks talked about it in relation to the stock market and used the recent declines as arguments for increased savings and thus increased investment. But this effect is independent of the proposed tax cut. The market has already fallen and this effect will (or will not) materialize without any regard to the tax cut. In fact, the tax cut would only work to blunt this effect by giving people more money.

3. Supply-side economics – many papers argued that the decrease in taxes would increase the multiplier in the multiplier-accelerator model of national income accounting and this would thus drive GDP growth, cascading into increased investment that would offset the savings drop. However, it is important to keep in mind that unemployment and capacity are already very low in the U.S. and an increase in consumption will most likely lead to higher inflation causing nominal but not real GDP growth. This would not help investments and might actually hurt as the inflation could lead to interest rate hikes. Additionally, supply-side effects have historically not been observed following changes in tax law (Reagan cuts in early 1980s, Clinton increases in 1993). Even if effects are to be observed from the current proposed tax cut, they will not be seen for a while as fiscal policy takes a long time to implement and run its course. Consequently, this should have only a minimal impact on the current or near-future economic status.