10. Program for a Strong America

Otto von Bismarck once said, "God provides for fools, drunkards, and the United States of America."

The US chronic trade deficits have done great harm to American workers, causing wages to stagnate and worsening the distribution of income. To undo such harm is itself sufficient reason to take immediate action to reduce the trade imbalances. But that may be the least important reason. The United States is faced with great dangers arising from the resulting deindustrialization of the American economy and the industrialization and resulting increased military power of a potential enemy, China, a totalitarian state and an imperialistic power, which has declared aggressive designs on Taiwan, occupies Tibet, has murdered hundreds of thousands of its own citizens, and supports murderous regimes in Burma,[1] North Korea,[2] and Sudan.[3] There is also increasing danger, the longer the trade deficits last, of a currency collapse in the United States that could possibly destabilize the economies of the entire world.

We have identified the causes of the trade deficits and the fact that a great majority of economists have dealt with the problem in an ostrich-like way, turning a blind eye to the problem, unwilling to recognize the potentially deadly reality. They attribute the problem to the flow of savings from abroad, which indeed is true, and believe countries will find it in their interest to begin investing those savings at home, as though the huge continuing and growing deficits were transitory! They also believe that the cause of the flow of capital to the United States is the low rate of US savings.

We argue that the deficits have induced Americans to save less and reduced the incentives of businesses to invest in the United States. We agree with the need to increase domestic savings and investment, and we devote much attention to the tax reforms necessary to encourage domestic personal and business saving and investment. But we believe that steps toward solving the trade deficit problem must occur at the same time.

Leading economists appear unwilling to acknowledge that countries are investing in US financial assets deliberately to promote their exports and minimize their imports, which we have called dollar mercantilism. The fact that the world has been on a dollar standard gives them the excuse that they are merely accumulating dollar reserves. Reserves of a trillion dollars?! Reasonable reserves for countries experiencing huge chronic surpluses are in the hundreds of millions or less. It is we who need to start accumulating foreign exchange reserves.

Actions That Need to be Taken

The second author of this work had the pleasure of working closely with psychologist, computer scientist, and Nobel Prize winning economist Herb Simon with whom he coauthored several theoretical psychology papers. One of Simon's most important contributions to the artificial intelligence field was the method of means-ends analysis, a method that intelligent systems (including people) use to solve defined problems.[4] Essentially, the method involves a system of planning how to get from where you are to the place that you want to be. Solving each part of the problem often creates new smaller problems, so the method works best if a goal is set to address the largest part of the problem. If, on the other hand, the largest part of a problem is ignored, then a means-ends problem solver sometimes "tinkers around the edges" without making progress toward a solution.

In order to deal with the problems of the American economy right now, the goal must be set to reduce the trade deficit. If we simply try to increase domestic savings without taking direct actions against the trade deficit, as the federal government did when it reduced the budget deficit during the late 1990s, mercantilist governments may again increase their financial investments, driving our real interest rates down as far as necessary, in order to force the trade deficit to continue. The consequence of trying to boost domestic savings without reducing the inflow of foreign savings would be more asset bubbles rather than a reduction in the trade deficit.

We can solve the trade deficit by enacting the program that we suggested in Chapter 4. Specifically:

1. *Restore the withholding tax on foreign financial investments*. Delete §871(h,i,k) and §881(c,d,e) from the Internal

Revenue Service code and terminate or renegotiate the tax treaties so that private-foreigners would pay a 30% withholding tax on any interest earned in the United States on their financial investments. This action would increase United States annual income tax collections from foreigners, raise American interest rates (which would encourage Americans to save) and lower the exchange rate of the dollar (making American exports more competitive in world markets and when competing with foreign imports in American markets). It would also improve American national security by encouraging foreign governments to put their money into American banks where their reserves could be frozen should they come into conflict with the United States. (If income taxes were replaced with the VAT or FairTax, the same effect could be obtained by withholding the VAT or FairTax from interest paid to foreigners.)

2. *Impose Import Certificates to balance trade.* Either the Richman plan or Warren Buffett's plan would work. Our plan, would just involve the dollar mercantilist countries and would have the Treasury Department auction the Import Certificates directly to importers with the proceeds used to buy mercantilist-country currencies; Buffett's plan would involve all of US international trade (except that the NAFTA nations could be given the option of joining the certificate plan so that intra-North American trade would be exempted). Our plan gives the dollar mercantilist countries a direct incentive to increase their imports of US goods and services; Buffett's plan definitely equalizes US trade with the whole world over a period of five years. Our plan could be implemented without change in the current rules of international trade; Buffett's plan subsidizes US exports and replaces the current international regulations designed to produce free trade with a new system, not needing regulations, that would produce balanced trade.
3. *Other Measures.* There are other steps that should be taken as well. Specifically, we should tax foreign dollar reserves, and the Federal Reserve should match foreign buildups of

dollar reserves through reciprocal purchases of the offending currency.

Whichever steps we take will have to be gradual as it will take time for American consumers to change their saving habits in response to higher interest rates, for American producers to invest in new production, and for foreign governments to increase the consumption of their own people to make up for the diminution of their trade surplus with the United States.

It will not be easy to get these steps through Congress. The first step, ending the private-foreign-savings tax loophole, will likely be opposed by shortsighted bankers who would put their own short-term benefit ahead of their long-term benefit and the benefit to our country.

The Import Certificates will also be a tough sell. Domestic manufacturers and American workers understand the problem and would line up behind a solution that would work. Unfortunately, many American corporations have already built factories in the dollar mercantilist countries. They will not want to see the rules of the game change in a way that would reduce their profits from those foreign factories. The question will be whether the long-term interest of America will take precedence over the short-term harm to profits from foreign factories.

These steps would directly address the largest of our problems. But as with many complicated problems, the process of solving the major problem creates new problems that are smaller, but still important. The new problem is that bringing down the trade deficit will bring down the inflow of foreign savings and cause long-term interest rates to rise.

To a certain extent, domestic savings will come back as a consequence. Businesses, both domestic and foreign, will find new opportunities for fixed investment in the US manufacturing sector. That sector will boom regardless of how high interest rates go, but it would be much better for our economy if interest rates did not go up too high or too fast.

We can encourage the comeback of domestic savings if we fix our dysfunctional tax system that encourages consumption of capital. A variety of steps are possible. Although our program could be enacted in a comprehensive way, it could also be put in place incrementally through gradual modifications of the existing tax code. The following steps could be taken:

1. *Tax capital gains based upon the Hicks-Richman definition of income*. The current personal income tax should be changed immediately because it is based upon an incorrect definition of income. Capital gains are only income if the capital upon which they are based is consumed. Capital gains from reinvested capital should not be taxed. Capital gains from consumed capital should be fully taxed. Capital gains from partly consumed capital should be partly taxed with the remainder of the capital gain subtracting from the basis of the reinvested capital. (If a true consumption tax is substituted for the personal income tax, as we suggest in item "4," then this provision would be irrelevant.)
2. *Move to a Proposition 13 Real-Estate Tax with a Homestead Exemption*. Real estate should only be reassessed when the property is purchased. The assessment should normally be the purchase price. Rate increases should be limited to the rate of inflation. There should also be a homestead exemption on the first $25,000 (or so) of the assessed value, to both encourage home ownership and also make the tax more progressive. These changes would make the real-estate tax more friendly to savings, home ownership, and fixed-investment.
3. *Eliminate the corporate income tax.* As personal savings have gone negative and the American federal government has run budget deficits, the one segment of the American economy that has continued to generate savings in recent years is the corporation. Eliminating the corporate income tax altogether would increase corporate savings leaving the corporation with more money for investment. It would also reduce the opportunity cost of capital faced by corporations and thus encourage them to invest in projects with lower expected payoffs. If

revenue were needed as a result of eliminating the corporate income tax, a VAT would be the best alternative because it would apply to imports as well as to domestically-produced goods. When the corporate income tax is eliminated, it will also be necessary to implement item "1", otherwise corporations would be used as tax loopholes in order to convert ordinary income into capital gains.

4. *Replace both income taxes with a true consumption tax.* Both the personal and the corporate income taxes should be replaced with a consumption tax. There are several alternative proposals available including the Value-Added Tax (VAT), the FairTax, and the USA Tax. The advantages of the VAT and FairTax are that they eliminate the personal income tax, greatly reducing the paperwork for US taxpayers and they are border-adjustable and so would level the international playing field for American producers. The FairTax and the USA Tax would be more progressive than the taxes replaced. The USA Tax is the most progressive of all, even without replacing the Social Security and Medicare taxes.

Essentially, we recommend that America tackle the trade deficit problem directly. This will create a smaller problem, the need for more domestic savings. We can increase domestic savings through a variety of changes in the tax code. Those changes could be minor, as proposed in Chapters 5 and 6, or more sweeping, as proposed in Chapters 7 and 8.

IMPROVEMENTS PROPOSED TO US TAX CODE

The solutions that we offer would eliminate tax loopholes, end double taxation, and simplify the tax codes. Specifically:

A. *These changes close tax loopholes:*

1. The foreign-savings tax loophole lets private foreign savers earn tax-free interest on approximately $4 trillion of savings (as of 2006). This loophole is not only unfair to American savers but it also causes trade deficits.
2. The foreign government savings loophole lets foreign governments earn tax free interest on approximately $3 trillion of

savings (as of 2006). This loophole directly subsidizes the deindustrialization of America by the dollar mercantilist countries.

3. American corporations have been buying back their shares, $230 billion in 2004 alone, partly to take advantage of the lower rate of taxation of consumed capital gains. The lower tax rate for consumed capital gains in the current personal income tax code counteracts the progressivity of the personal income tax and is causing the consumption of American wealth.

B. *These changes end double taxation:*

4. Individuals are double taxed on reinvested capital gains, first when they realize the gain and second when they earn income on the reinvested portion of the capital gain. The income received from the reinvested capital is taxed although its capital value had been taxed. This encourages taxpayers to consume the entire capital gain rather than have it taxed again on its income. Thus the current treatment encourages the consumption of capital rather than the holding of the asset for its future stream of income, especially when the income is taxed at a higher rate than capital gains are taxed.
5. Shareholders of corporations are double taxed, first when the income of the corporation is taxed and second when they pay tax on dividends or capital gains. Replacing the corporate income tax with a value-added or sales tax would eliminate this double taxation as well as enhance investment and level the international trade playing field. Eliminating the corporate income tax, however, would open up new tax loopholes if dividends remain taxed at lower rates as is now the case and if consumed capital gains remain taxed at lower rates than ordinary income is taxed.

C. *These changes simplify tax codes:*

6. Eliminating the lower rate of taxation of consumed capital gains would allow all income to be taxed at the same rate, eliminating much of the complexity of the current tax code.
7. Assessing properties at their sales price when purchased would

greatly simplify property tax codes and would make property tax rates less volatile when asset values rise and fall.

8. Replacing the income taxes with the VAT or the FairTax would greatly simplify the tax codes faced by US corporate and personal income tax payers.

Innovations to Economic Theory

In this book, we have made the following contributions to economic theory:

1. The economic theory that proves the advantages of free trade only applies when trade is relatively balanced. If trade is balanced, all parties benefit. But government-manipulated "free" trade can allow one country to steal industry from another. (See Chapter 1.)
2. The decline in US personal savings is not the cause of the inflow of foreign savings, but the result of that inflow. (See Chapter 2.)
3. Import certificates auctioned either by the US Treasury or distributed to exporters in proportion to exports, would jump start American manufacturing investment and balance trade. (See Chapter 3.)
4. The lack of differential between US taxation rates of private-foreign-savings and public-foreign-savings poses a security threat to the United States because it lets foreign governments put their reserves in foreign banks without interest penalty and without danger of their funds being frozen. (See Chapter 4.)
5. The proposed Hicks-Richman definition of income is an improvement over previous definitions because it correctly categorizes consumed capital gains as income and reinvested capital gains as future income which should not be taxed until the future. This improved definition leads to a proposed innovative method of taxing capital gains under an income tax that is neutral with respect to the timing of when capital is consumed. (See Chapter 5.)
6. Since real-estate taxes are borne by the land owner, changes

like California's Proposition 13 make the real-estate tax more certain, more fair, and less expensive to administer. (See Chapter 6.)

7. The changes we propose in the capital gains tax make it possible to eliminate the corporate income tax without creating tax loopholes. (See Chapter 7.)
8. The Flat Tax is not a consumption tax. It is a tax on the value-added of production (income) not the value-added of consumption. (See Chapter 8.)
9. The FairTax could be collected exactly the same way as the VAT, except that the tax would be visible on all sales receipts. This would greatly reduce the potential for tax cheating under the FairTax. The cost of tax compliance for the FairTax could then be predicted as being just 3% to 5% of tax collected, as compared to the 12% to 15% cost of compliance with the current income tax code. (See Chapter 8.)

A Reason for Optimism

In the past, America has sometimes let problems fester until they became disasters. Slavery is a prime example. The growth of fascism in Germany is another. Dollar mercantilism may be a third. It very well may be that we won't have the political will to do anything about dollar mercantilism until after a hard landing leaves America with high inflation and a reduced standard of living.

But America has always come back. Whenever things have gotten bad enough, we always have found a Madison and Hamilton to pull our country together with a new constitution, or a Lincoln to fight the hotheads until union is restored, or an FDR to lead us through the depths of depression and war. None of these leaders acted alone. They all called upon the can-do spirit of a nation of problem-solvers. The solutions we suggest in this book could work to prevent the crash or could work after the crash to speed the recovery.

In 1929, economists were similarly caught with their heads firmly planted in the sand. The Federal Reserve did not yet see itself as responsible for maintaining a growing money supply. Finally, in 1932 Illinois Congressman A.J. Sabath and Treasury Secretary Ogden L.

Mills forced the Federal Reserve to take actions that would start making the depression better, not worse.[5]

The economics profession has again been caught with its collective head in the sand. But the American people know that something is wrong. There is growing awareness of Chinese government currency manipulations, one of the main drivers of the US trade deficits, and growing support for the FairTax, one of the best solutions to our faulty tax system. There is a solution within our reach today and it is not yet too late.