Trade deficits, free trade and self-destructive U.S. tax policies
An informed letter from Roger Conklin

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Dear Sirs,

I'm pleased that you addressed the subject of Trade at the Midterms in the November issue of ***The Comparative Advantage***, but disappointed that you did not address the prime reason why free trade has produced such negative results for the United States and, regardless of who comes out on top in the elections, is likely to result in a retreat from trade liberalization and corrective action to make it beneficial to the U.S. This will inevitably aggravate the current trade deficit and damage the middle class even further. Foreign trade and the trade deficit are serious problems that are not being addressed by either party.

The question I suggest your team address is: Why has free trade been so beneficial for most countries but such a disastrous albatross for the U.S.? Yes, our population has benefited from reduced costs to consumers and households, but at the cost to the U.S. of a most horrendous and totally out-of-control trade deficit that is simply not sustainable. It has unquestionably also cost several million U.S. domestic jobs instead of creating more jobs. Whenever an individual, a company or a national economy spends more for what it buys than what it sells or earns, there comes a day, sooner or later, when the bill has to be paid. There is no free lunch. Why is it that among the developed and industrialized economies of the world, except for a very few, almost all have trade surpluses? And among those "very few" that have trade deficits, why is the U.S alone as the only country with a massive trade deficit that grows each year by double-digit percentages? Simply compare the performance of the U.S. with that of Germany. In 2005 the U.S. trade deficit was a record $716.7 billion. Germany, the largest exporter in the world with an economy and population ¼ that of the U.S, exports **over 4 times per capita** more than the U.S. with a record 2005 **trade surplus** of $192 billion. And the EU is a free trade zone. This is even though Germany's per-capita imports are 70% higher than the U.S., its wages, manufacturing costs and taxes are higher than ours and it is even more dependent on imported petroleum than we are.

There is a very clear and identifiable reason for the massive trade deficit of the U.S. and, in contrast, the healthy trade surplus of Germany, most other developed countries and many developing countries as well

What is this reason? Until the 1970s the U.S. had never in the 20th century had a trade deficit. The very last U.S. trade surplus, which was also the very largest in the nation's history, was $12.4 billion in 1975. The very next year, 1976, our trade balance was abruptly transformed from this substantial surplus into a $6.1 billion deficit. And it has been straight down hill ever since. There was a significant event, the Tax Reform Act of 1976 that erected an immediate and significant barrier to the export of both U.S. goods and services. This barrier was erected not by any foreign countries, but by the U.S. against itself.

But the roots of that barrier go back even further to the Revenue Act of 1962, signed by President Kennedy, planting the seeds for transforming the always-positive U.S. trade surplus into a trade deficit which has totaled $2.974 trillion in the last 30 years. That 1962 Act for the first time made the United States the only country in the world to levy a double income tax on its citizens who live, work and are bona fide residents abroad.. Overseas citizens, (except diplomats) are generally fully taxed on their worldwide income by the foreign governments where they live just like resident foreigners in the U.S. are taxed by the IRS. No other country (with the possible exceptions of North Korea and Zimbabwe)

taxes its own non-resident citizens. All countries apply their tax laws to everyone, citizens or non-citizens, who live within their borders. The 1962 legislation was directed specifically at Hollywood movie stars living and filming in Mexico where income taxes were lower. The objective of double taxation was not to increase tax revenues but to penalize them tax-wise so they would come home. And indeed they did. There was a fairly generous exclusion in that legislation from U.S. taxation on the first $25,000 of income earned abroad. That was a lot of money 44 years ago, so for other than the targeted high-salary movie stars, few Americans abroad were really affected by this legislation. It produced little tax revenue from overseas U.S. citizens but it did meet its objective of discouraging Americans from living and working abroad.

But the 1976 legislation, co-sponsored by a freshman Congressman from Iowa, Charles E. Grassley, made radical changes in the 1962 law. It reduced the foreign income exclusion to $15,000, taxed all income above the exclusion at the marginal rates applicable as if the $15,000 had not been excluded and established tighter limitations on applying foreign income tax credits against the U.S. tax obligation. Taxes on income received in foreign currencies had to be paid in U.S. dollars irrespective of local currency laws which might prevent the exchange of such foreign currency income for dollars for this purpose. And the Act, signed by President Ford in October 1976 was retroactive to January 1. The courts also ruled that previously tax free reimbursements necessary and provided by employers to overseas personnel would be taxed. These reimbursements typically include tuition for children in English-language schools abroad, housing cost allowances for high rental cost areas, security guards, employer-provided local transportation, food and housing at work camps and air transportation for obligatory periodic home leave. Reimbursements for taxes were made taxable. The immediate result was disastrous on overseas Americans and their employers. It made U.S. citizens totally non-competitive for most overseas employment.

I was managing director of a Brazilian-owned company marketing US telecommunications products in Brazil. Starting from zero I sold $16 million in U.S. exports in 2 years. With the enactment of the TRA of 1976 my combined Brazilian plus U.S. income tax obligation shot up to more than double that of any non-US citizen in Brazil with my exact same income. I could not survive, so the business was shut down and I came back home. A French company with no prior presence in Brazil quickly moved in and took over the market I had opened which today accounts for $1 billion/year in French exports to Brazil. The U.S. share of that market, as a direct result of the 1976 tax legislation, today is zero. Just 718 cases like mine, and there were many more, account for today's $718 billion trade deficit. It is just that simple.

Testimony presented before Congress by individuals, businessmen, the GAO and others substantiated that this Act and the court rulings resulted in many overseas Americans suddenly being confronted with U.S. tax obligations that exceeded their salaries. Hundreds of thousands of overseas Americans lost their jobs or resigned voluntarily and returned home. One example cited by the GAO in congressional hearing testimony was a married Bechtel Corporation engineer in Saudi Arabia with a $40,000 salary whose U.S. tax obligation was $51,000. The home-country tax obligation of any non-U.S. citizen with this exact same salary and job is zero. Employers abroad, both American and foreign, scrambled to replace Americans with non-Americans because of the unaffordable double tax cost on wages and reimbursements required for Americans to survive. Entire American industries, such as those engaged in overseas engineering and construction projects where U.S. companies had always been No.1, disappeared because these new tax costs drove many into bankruptcy and totally destroyed the ability of such firms employing U.S. citizens to compete internationally. The massive market for pull-through goods created by this industry was lost to the U.S. and instead went to the countries' companies who took over the international project and construction market. And most importantly, the effective network of overseas U.S. citizens that had always insured a

positive U.S. trade balance was almost totally decimated by the enactment of this legislation. The effect was immediate with the registration of a $6.1 billion trade deficit in 1976.

This disaster caused Congress to hold hearings to find out what had gone so drastically wrong. I was among those who testified before the House Ways and Means Committee in 1978 and the Senate Finance committee in 1981. Congress had retroactively postponed the effective date of this 1976 legislation by a year in 1977; but the damage had already been done and those affected had already lost their jobs. Subsequent band-aid legislation undid some of the most draconian provisions of the 1976 law but fell far short of correcting the vary basic and serious problems resulting from double taxation of U.S. citizens abroad.

In 1979 President Carter, alarmed by a 480% increase in the trade deficit in just 2 years, appointed The President's Export Council made up of several prominent businessmen and including the eminent senators Adlai Stevenson (D, IL) and Jacob Javits (R, NY) and Congressman Bill Alexander (D, AR) which recommended unequivocally the abolition of double taxation by the U.S. of Americans resident abroad. Congress commissioned the GAO to perform a study, which resulted in GAO Report "American Employment Abroad Discouraged by U.S. Income Tax Laws," ID-81-29 of February 1981. Both reports predicted massive trade deficits if the recommended action was not taken to eliminate this double taxation. But the recommendations in both reports were ignored and the trade deficit today is 120 times greater than in 1976. The YTD results point to a $920 billion trade deficit for 2006; up 28% from last year.

The U.S. problem is not that we import too much, but that we export so little. Today China is the 3rd largest export market in the world, yet the U.S. captures only 6% of that market. Both Korea and Japan have healthy trade surpluses with China. The EU, roughly the same economic size as the U.S., sells twice as much to China as we do. Our Treasury Secretary blames our trade deficit with China on the pegging of the Yuan to the dollar and looks for a sure solution in a floating Yuan. We have a floating exchange rate with Europe, but between 2001 and 2005 the Euro increased 52% in value with respect to the dollar. Did this solve our trade deficit problem with the EU? Quite the contrary, during this same 4 year period our annual trade deficit with the EU **increased** by 42%.

President Bush in 2001 committed to "Level the playing field to sell American goods and services across the globe." It is U.S. tax law that is primarily responsible for this non-level playing field. It is directed not against foreigners, but against our own citizens and U.S. companies. Without "feet on the ground" in foreign markets we are not present and competing to sell U.S. goods and services. This is not the fault of free trade, China or any foreign government. It is a problem created by our own government by double taxing Americans so they will stay home and not go abroad to capture markets for American exports. It is our trade competitors, not the U.S., who already have vast numbers of their citizens living in China and exploiting the Chinese market that will profit most from any revaluation of the Yuan. Germans in the U.S. pay only U.S. taxes which are less than in Germany. Americans in Germany not only pay high German taxes, but U.S. taxes as well. The latest available information from the Treasury Department published in February 2004, indicates there were a total of 5,103 U.S. tax returns submitted for tax year 2001 from China: 303 self employed, 1,622 with foreign employers, 2,403 employed by U. S companies, 300 by their foreign affiliates and 475 "other." A Pretty inadequate U.S. presence for the 3rd largest export market in the world.

There are currently 2 identical bills in Congress, S.3496 submitted by Senator Jim DeMint and H.R.5986 by Congressman Chris Chocola. Both are titled "Working American Competitiveness Act." Both have several co-sponsors and both would removed the ball and chain of the double taxation burden imposed on U.S. citizens, thus leveling the playing field so the U.S. can, like the rest of the world, compete to reap the benefits of

free trade. The Commerce Department's estimate is that between 10,000 and 20,000 domestic jobs are created by each $1 billion in exports. It is the failure to export, not free trade that is destroying our middle class. Congress needs to understand that.

It is interesting to note that Senator Charles E. Grassley, a co-sponsor of the TRA of 1976 and now chairman of the Senate Finance committee, was the person who at the very last minute, just before the final vote, introduced a provision in the recently-enacted Tax Increase Prevention Reconciliation Act – TIPRA that further increased the taxes on U.S. citizens overseas. That provision was inserted with no discussion or hearing the day it was voted on and passed. The immediate result is that more overseas Americans have already headed back home abandoning more markets to foreign competitors.

I urge you to include in a near-future follow up article on this subject the influence of double taxation on the failure of free trade and the necessity of removing the double taxation handicap our legislators have imposed and are maintaining against our own national interest.

Please let me know if you have any doubts.

Yours truly,

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