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ECONOMY | CAPITAL ACCOUNT

Donald Trump's Tax Pitch Could Miss Trade's Strike Zone

GOP presidential nominee wants a smaller trade deficit, but his deficit-financed tax cut could do the opposite

Ronald Reagan was a reluctant protectionist; not Donald Trump, whose first instinct if confronted with a deepening trade deficit would be tariffs or other penalties. *PHOTO: MARK REINSTEIN/ZUMA PRESS; JEWEL SAMA/AGENCE FRANCE-PRESSE/GETTY IMAGES*

By **GREG IP**
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Of the countless political positions Donald Trump has held over the years, the most enduring is his belief that unfair foreign competition has saddled the U.S. with a crippling trade deficit. Shrinking that deficit by rewriting trade deals and imposing tariffs is now the cornerstone of his platform.

It is thus ironic that the rest of his economic pitch, if enacted, would likely accomplish the opposite: a bigger, not smaller, trade gap.

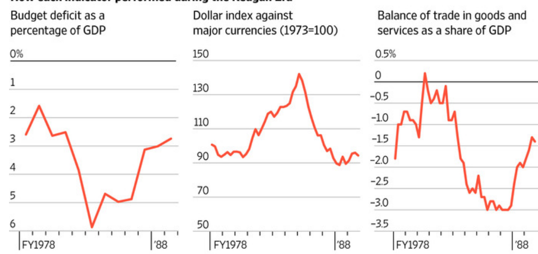
Conventional economics predict that the Republican presidential nominee's deficit-financed tax cut would drive up interest rates, sucking in foreign capital and driving the dollar higher. The result would be higher imports, weaker exports and more foreign debt than otherwise, developments likely to intensify Mr. Trump's protectionist instincts.

Mr. Trump's economic advisers disagree. A paper prepared by Peter Navarro, an economist at the University of California at Irvine, and investor Wilbur Ross predicts Mr. Trump's economic plan would eliminate the trade deficit by taking a tough negotiating stance with foreign trading partners.

But that is out of step with standard economics, which predicts that a country's trade balance is determined by the gap between what it invests and saves, not by tariffs.

It is also at odds with experience. In the early 1980s, Ronald Reagan's tax cuts and military spending soaked up national saving while the Federal Reserve, determined to slay inflation, raised rates repeatedly. The budget deficit and high interest rates together sucked in foreign capital and sent the dollar up 49% between 1980 and 1985.

The trade deficit leapt from 0.5% of gross domestic product in 1980 to 2.6% in 1985. Mr. Reagan was a free trader, but under intense pressure from Democrats in Congress and business, he enacted a series of protectionist measures such as voluntary export restraints on Japanese car exports. It didn't help: The trade deficit kept growing.



I asked Macroeconomic Advisers, an econometric consulting firm, to simulate the effect of a 10-year, $4 trillion tax cut—at the low end of how much Mr. Trump's tax plan is thought to reduce federal revenues. The initial tax cut would modestly nudge down unemployment. But the firm concludes the Federal Reserve won't let unemployment go much lower for fear of inflation, and will ultimately respond by raising interest rates over the period to 4% instead of 3.25% without the tax cut.

Assuming foreign interest rates don't change, the firm predicts the dollar would jump and the trade deficit by 2026 would reach almost $1 trillion, 22% more than without the tax cut. Meanwhile, higher interest rates boost what the U.S. must pay foreign lenders. The current-account deficit, the imbalance on all trade and investment income with foreign countries, would thus climb to nearly $1.4 trillion, or 47% more than without the tax cut.

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The firm does find that lower tax rates, which are meant to encourage work and investment, modestly bolster the country's underlying growth potential but that benefit is offset by higher interest rates, leaving overall growth little different and the budget deficit 80% larger.

Perhaps interest rates wouldn't go up, because Janet Yellen, the current Fed chairwoman, or whomever Mr. Trump appoints to replace her, isn't worried about inflation. Or as the Tax Foundation, a think tank, claims, foreigners would happily lend the U.S. all it needs at the current interest rate (a view the Congressional Budget Office doesn't share).

In that case, the Tax Foundation's analysis finds, Mr. Trump's tax-rate cuts are great for investment and growth, and that reduces the resulting budget deficit by 33% to 40%. But that scenario also requires more foreign borrowing and a bigger trade deficit. "Obviously there would need to be substantial importing" of investment in response to the corporate tax cut, said Alan Cole, who conducted the analysis.

Mr. Navarro and Mr. Ross claim Mr. Trump's plan to slash regulation and open more federal land for oil, gas and coal extraction would bolster growth enough to neutralize the tax cut's deficit impact. But that conclusion rests on tenuous assumptions. For example, they assume that less regulatory spending, such as on pollution abatement equipment, raises GDP (it might in the long run, but not the short run), that oil companies would rush to drill on newly opened federal land despite today's depressed prices and that there are huge, hidden reserves of unemployed workers.

Mr. Reagan was a reluctant protectionist; not Mr. Trump. His first instinct if confronted with a deepening trade deficit would be tariffs or other penalties.

Yet experience and theory suggests such actions wouldn't narrow the deficit and might well do the opposite. Judging by how the Mexican peso has gyrated with Mr. Trump's election fortunes, the currency would likely plunge if he became president, while a trade war could tip Mexico into recession, developments that are unambiguously bad for U.S.

companies trying to sell to Mexico.

Mr. Trump, then, would almost certainly have a big impact on trade. It just may not be the impact he intended.

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