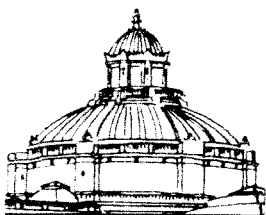


Issue Brief

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THE CASE FOR AND AGAINST AN IMPORT SURCHARGE

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ISSUE DEFINITION

The United States is now running a deficit of over \$100 billion in its foreign trade and the Federal budget is in the red by roughly \$200 billion. To deal with these two deficits, Congress is considering a temporary import surcharge. This brief examines the case for and against such a surcharge as well as its use against Japan.

BACKGROUND AND POLICY ANALYSIS

The Case for an Import Surcharge

The case for an import surcharge is straightforward:

- Imports should be taxed to offset the "subsidy" of 30% to 40% which is given to foreign goods as the result of the overvalued dollar. Such a tax would reduce imports and ease the heavy burden placed on U.S. industry and labor.
- An import surcharge of 20% the first year would raise \$60 to \$75 billion in Government revenue, making a sizeable reduction in the budget deficit. A reduction in the budget deficit should bring down interest rates and the overvalued dollar. Moreover, with a smaller budget deficit, U.S. monetary policy could be eased (to maintain the pace of economic recovery and avoid a rise in unemployment), putting further downward pressure on interest rates and the dollar.
- Since foreign exporters to the United States would want to preserve their market shares in the face of a temporary tax, they would probably absorb part of the tax, especially on manufactured goods. While this would reduce government revenue and slow the cut in imports, it implies that foreigners would be paying part of the surcharge. (Such "payment," however, would be to the national economy not to the U.S. Treasury.)

Clearly, such developments would benefit U.S. industry, agriculture and home buyers and builders.

The Case Against an Import Surcharge

The case against an import surcharge rests on three arguments:

- Though the surcharge would reduce U.S. imports, it would do so at the expense of U.S. exports; they would fall if, as is likely, the dollar were to rise, and foreign incomes were to fall as their exports to the United States were reduced, and if foreign countries retaliated, as is possible.
- The import surcharge would raise serious economic and

political problems in U.S. relations with other countries;

-- Most of the positive benefits of the surcharge flow from the fact that the revenues collected would reduce the budget deficit.

An import tax is not the best tax to use to reduce the budget deficit.

Let us run through the economic and political analysis of an import tax in more detail.

1. Coverage of surcharge: The basic proposal is to have the surcharge applied to all U.S. imports. There is reason to expect pressure from our neighbors in the Western Hemisphere to be exempt from the surcharge: -- One-fifth of U.S. imports come from Canada. It depends very heavily on exports to the United States for its economic growth. Indeed, 20% of Canada's output is exported to the United States. Moreover, it has an agreement with us providing for duty-free trade in automobiles. The import surcharge would hinder Canada's economy and abrogate the automobile agreement.

-- Thirty percent of U.S. imports come from Mexico, Brazil, Argentina and the other large international debtors. They depend on exports to the United States to pay off their debts and to pull themselves out of the deepest recession since the 1930's. The surcharge would constitute a major obstacle to their continued recovery and their ability to pay on their heavy indebtedness to U.S. banks.

If exports from the Western Hemisphere were exempted from the surcharge, as seems quite possible, the revenues raised would be cut in half.

From a commodity rather than country point-of-view, would the tax be applied to the one-third of U.S. imports which are duty-free? By and large, they are used as inputs for U.S. manufacturing or do not compete directly with U.S. products; and taxing them would raise prices to U.S. users. Second, would the surcharge apply to goods that are protected by quotas, notably steel, textiles and apparel? Such goods were exempted from Nixon's 1971 import surcharge of 10%.

2. Retaliation and other Repercussions: There would be great pressure for the European Community (EC) to retaliate against the U.S. surcharge, even in the unlikely event that it were found to be consistent with U.S. obligations under the GATT (General Agreement on Tariffs and Trade). The European Parliament (of the EC) has passed a resolution proposing retaliation and several spokesmen for the Community have endorsed the idea. Indeed, some Europeans are looking for opportunities to restrict specific U.S. exports, notably soybeans. If there were retaliation, it would hurt U.S. exports, offsetting some of the hoped-for trade benefits.

Despite the parliamentary resolution, it is far from certain that the Community would retaliate. The member governments would find it difficult to agree on a course of action.

More likely than retaliation would be emulation. Other countries would feel freer to use import surcharges. While the United States imposed an import surcharge in 1971, that was in a period of fixed exchange rates. To do so today, in a world of flexible exchange rates, would establish a precedent.

It is interesting to note that a 20% surcharge on all imports (dutiabale and non-dutiabale) would make the United States more protectionist than it has been in modern times. Today's overall average of 3% would go to 23%; the Smoot-Hawley tariff raised the average to 20% (though the average charge on dutiabale goods alone was about 59%); only in 1906 did average U.S. tariffs reach 24%. The United States has quotas on imports of textiles and apparel, steel and other goods today, while such quotas were not applied significantly before World War II.

It seems clear that a surcharge would exacerbate relations with our major allies, divert attention from, and probably undercut, U.S. proposals for a new round of trade negotiations, and set a dangerous precedent for dealing with trade problems in a world in which such problems were to be met by flexible exchange rates and sensible domestic policies.

3. Economic Analysis of the Surcharge: Because the impact of the proposed surcharge works directly on two factors -- imports and the budget deficit -- it makes sense to simplify the problem and consider separately the repercussions of each of these two factors on the economy:
 - a. Imports. The surcharge would, at least initially, cut imports. The amount and duration of the cut depend on how much of the tax is absorbed by the foreign exporter (or U.S. importer), the sensitivity of U.S. demand to the new price and, the movement of the exchange rate.

Without taking account of the trade effects produced by the reduction in the budget deficit, the initial cut in imports would tend to bring a virtually equal cut in exports. This is so because the fall in imports would see fewer dollars being made available to the foreign exchange market. As a result, the dollar would rise. In addition, the surcharge would lead to higher U.S. prices and, consequently, higher U.S. interest rates, attracting foreign capital and adding further upward pressure on the dollar. In short, conventional economic analysis suggests that gains made by U.S. industries which compete with imports would be substantially, if not entirely, offset by losses to U.S. exporting industries.

- b. Budget Deficit. The best effect on U.S. foreign trade and the U.S. economy comes from the increase in Government revenues and the reduction in the budget deficit. The result would probably be easier monetary conditions, lower U.S. interest rates, a reduced net inflow of capital, and a lower dollar.

Would this overwhelm the forces leading to a higher dollar, noted before? No one can be sure. The DRI (Data Resources, Inc.) model suggests that this would not happen and that, on balance, the proposed import surcharge would lead to an appreciation of the dollar (though less than would result solely from a cut in imports). In short, there is widespread agreement that the revenue effects of the surcharge would have desirable implications for the U.S. economy.

Is an import tax the best tax for the United States to use to reduce the budget deficit? An import tax raises the price level, alters relative prices and distorts the flow of resources. An alternative would be a general excise tax which also raises prices but on a broader range of goods and consequently does not give windfall profits to import-competing firms and does not impose windfall costs on U.S. importers and exporters. Alternatively, an increase in income taxes could have the same revenue effect without raising prices, distorting the flow of resources and risking retaliation. The task is to select a politically feasible tax that will raise sufficient revenue with the least distortion in the flow of resources and the least amount of international disruption.

Import Surcharge on Japanese Goods

There are proposals to place an import surcharge exclusively on Japanese goods. Since the increase in Government revenues would be small, \$6 to \$10 billion, such a measure would have a much smaller effect on the U.S. budget than a general import tax. Thus, the surtax on Japanese goods should be examined more from the point of view of trade and foreign policy.

The U.S.-Japan trade problem is serious. But Japan is only one of our problems. From 1980 to 1984, the U.S. trade balance worsened with virtually every country. With Japan, it deteriorated by \$25 billion. With Western Europe, the deterioration was \$36 billion.

A tariff aimed at Japan alone would further erode the principle of MFN (most favored nation, or non-discriminatory,) treatment, one of the cornerstones of GATT and U.S. foreign trade policy. Non-discrimination is crucial for the world's economy. In addition to its important political attributes, non-discrimination implies that each country will get its imports from the most efficient supplier, or, as a GATT report states, non-discrimination "ensures that a given level of protection of domestic producers is achieved at the minimum cost for both the protecting country and

the rest of the world." Moreover, enforcement of a discriminatory tariff would be difficult, as trans-shipment and fraudulent invoicing would be encouraged.

Nevertheless, Japan's trading practices raise questions about how to deal with a country which may be violating agreed rules of international trade. The normal course of action would be to raise the issues with the contracting parties to the GATT. If Japan were found to be in violation of the GATT, the United States (and others) would be entitled to take retaliatory action. Unilateral action of the type now being considered by the Congress may be appropriate to get greater market access to Japan's market. But this paper does not analyze this issue. Rather it focuses on how to deal with a country running a large, destabilizing trade surplus.

There are costs and benefits to a tax on Japanese goods for this purpose. The costs are clear. American consumers, importers, and retailers would face higher prices. U.S. manufacturers using Japanese products would also face higher prices, making it even more difficult for them to compete on world markets. However, the objective of the tax is to shock Japan into opening its markets wider to U.S. goods. But would the tax or even the opening of Japan's markets reduce Japan's trade surplus? Apparently, it would not.

The basic reasons for Japan's huge trade surplus are similar to (but the reverse of) the reasons why the United States runs a huge trade deficit. In Japan, savings are high. Japan saves more than it invests at home. The excess of domestic savings over domestic investment turns up as foreign investment or an export surplus, the way real resources are transferred abroad. Put another way, the excess of savings over investment in Japan results in low interest rates; with low interest rates there is a tendency for Japanese funds to be invested abroad; the yen is sold and dollars are bought so that the yen becomes cheap, stimulating Japanese exports and reducing imports.

The United States, on the other hand, has low personal savings. They are not high enough to cover domestic investment and the government deficit. We consume and invest more at home than we produce. The difference is made up by importing more goods than we export. The mechanism for achieving this is the high interest rate which develops as private investors and the U.S. Government borrow more than Americans save; the high interest rate attracts foreign funds, bidding up the dollar; the result is higher imports and lower exports, providing the United States with the real resources it needs to sustain its domestic investment and government expenditures.

In short, unless Japan were to increase its budget deficit -- it now has the tightest fiscal policy of any major industrial country, to tighten its monetary policy, or somehow to reduce personal savings, Japan is likely to continue to run a huge export surplus.

This does not mean that Japan does not have a closed market for many goods. It probably does. Yet its foreign trade surplus has risen while it has been opening its economic borders in recent years. Opening Japan's market further, while desirable, would not eliminate its trade surplus, for reasons noted above. Imports of some products would rise but the trade surplus would persist.

Moreover, it is important to recognize that the United States places a major burden on our tradeable goods sectors by following policies which have produced an overvalued dollar. In effect, the high dollar taxes U.S. exports

to Japan and subsidizes U.S. imports from it by 20-30%. Under these conditions, it is not difficult to explain the huge Japanese trade surplus and U.S. deficit.

Trade Policy Considerations

To deal with a balance-of-payments problem, the GATT allows the imposition of temporary import restrictions under Article XII. Import duties, however, are not legitimate but quantitative restrictions, (QR's) or quotas, are. Such restrictions can only be justified under the GATT when they are used "to forestall the imminent threat of, or to stop, a serious decline in...monetary reserves."

It would be difficult for United States to argue that it is threatened by a loss of monetary reserves; these have risen from \$19 billion in 1976, to \$27 billion in 1980 and \$34 billion in 1984. While it is recognized that the United States has a foreign trade problem (though, according to leading estimates, two-thirds of it are the result of the overvalued dollar), the balance-of payments clause of Article XII of GATT presents a problem for justifying the surcharge.

On the other hand, the contracting parties to the GATT decided in 1979 that import restrictions to protect the balance of payments shall be subject to Article XII (and XIII and XVIII) of GATT, but that preference shall be given to measures which have the "least disruptive effect on trade." The United States argues that an import surcharge is less disruptive than quotas.

The question is less one of legality under GATT than of the appropriateness of import restrictions to deal with an overvalued currency. Foreign officials would argue, as U.S. officials have in the past, that first step is to get the budget deficit under control.

President Nixon's 10% import surcharge of 1971 is pointed to as precedent. But its objective was to shock other nations into agreeing to a substantial appreciation of their currencies against the dollar in a period of fixed exchange rates. The situation is different today when exchange rates are floating. (It is interesting to note that the surcharge lasted only from Aug. 15, to Dec. 19, 1971, and that half of U.S. imports were exempt from the tax.) A GATT Working Party reviewing the 1971 surcharge found that it was not appropriate at that time. It might well conclude that it is even less appropriate today.

A Summing Up

The most compelling argument for an import surcharge is that it would have a salutary effect on the U.S. economy through reducing the budget deficit. In best case circumstances, a smaller budget deficit might conceivably overwhelm the effect of reduced imports and higher U.S. prices and edge the dollar down. Moreover, an import surcharge is a tax with some political attraction, and thus feasibility, at home.

However, the case against such a tax is strong. It has serious drawbacks from the point of view of trade and foreign policy and, indeed, from the view of avoiding price rises and creating a more efficient tax structure.

The surcharge functions as a tax -- a temporary and declining one. Thus,

a central question posed for policymakers is whether there are alternative taxes which do not have the negative economic and political results projected for a tax on imports alone.

LEGISLATION

H.R. 1139 (Schulze et al.)

Imposes a 20% import surcharge to be removed country-by-country as it concludes a bilateral free trade agreement with the United States. Introduced Feb. 19, 1985; referred to more than one committee.

H.R. 2120 (Lundine)

Proposes a surcharge on all imports for 2 years, 20% the first 8 months, 15% the second 8 months, 10% the third (and last) 8 months. The surcharge is conditional on getting a cut of \$40 billion in the budget deficit each year. President can reduce surcharge by half for heavily indebted countries. Introduced Apr. 18, 1985; referred to Committee on Ways and Means.

H.Con.Res. 107 (Rostenkowski et al.)

On Apr. 2, 1985, the House passed a resolution by 349-19 urging the President to take "all appropriate measures" to get Japan to end unfair trade practices. The resolution also placed part of the blame for the U.S. trade deficit on the strong dollar and the budget. Introduced Apr. 2, 1985; referred to Committee on Ways and Means. Reported Apr. 2 (H.Rept. 99-35).

S. 761 (Murkowski)

Imposes a surcharge on imports from countries that maintain large current account surpluses with the United States. If the current account surplus is above \$16 billion each year for 3 years in a row, the charge would be 20% for 1 year. If Japan were to run a large surplus again this year, as expected, it would be the only country to qualify for the 20% surcharge of the bill. Next year it could qualify for a 35% surcharge. Introduced Mar. 26, 1985; referred to Committee on Finance.

S.Con.Res. 15 (Danforth et al.)

On Mar 28, 1985, by a vote of 92-0, the Senate passed a non-binding resolution requesting the President to take retaliatory trade measures against Japan unless it opened its markets to U.S. goods. Introduced Feb. 20, 1985; referred to Committee on Finance. Reported Mar. 28, 1985, amended and without written report.

S. 770 (Heinz)

Proposes a 20% tax on imports for Japan for 3 years. Introduced Mar. 28, 1985; referred to Committee on Finance.

S. 1404 (Danforth)

On July 9, 1985, the Senate Finance Committee reported out a bill which "determined" that Japan uses unfair trade practices and requires the President to have them eliminated or to retaliate in 90 days (S.Rept. 99-102). The minimum target is to negate the cumulative impact of the removal of voluntary export controls over autos, suggesting that the President's actions must have a \$3 to \$4 billion effect on increasing U.S. exports to Japan or decreasing U.S. imports from that country. S. 1404 was

introduced July 9, 1985; referred to Committee on Finance.