THE NOBEL PRIZE WINNER DISCUSSES THE EFFECTS OF INTERNATIONAL POLITICAL/ ECONOMIC EVENTS ON U.S. CORPORATIONS AND FINANCIAL PROFESSIONALS.

# Robert Mundell on Economic Recovery

BY RAMONA DZINKOWSKI

Following one of the most difficult periods in the U.S. economy since the 1920s, senior financial managers are now faced with a barrage of new domestic and international issues that could have serious implications for their companies. The proposed Bush economic stimulus plan promises to increase the availability of investment capital and stimulate growth in certain sectors of the economy. Meanwhile, the international political and monetary climate has created market jitters at a time when investors are desperate for stability and clarity. In an exclusive interview for *Strategic Finance*, Dr. Robert Mundell, distinguished professor at Columbia University and 1999 Nobel Prize Winner in economics, explains how these and other political/economic issues will impact U.S. corporations and add to the complexity of financial management practices and strategy in the coming year.

Dr. Mundell is the author of many works and articles on economic theory of international economics and formulated what became a standard international macroeconomics model. He was also an originator of supply-side economics and is considered the "godfather" of the euro. Among other distinguished honors, Dr. Mundell was awarded the Nobel Prize in Economic Science in 1999 for his work on the effects of monetary and fiscal policy under alternative rate regimes.

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RD: **Some would argue that the economic stimulus contained in President Bush's tax reduction plan wasn't necessary since the U.S. economy was already on the road to recovery and remains one of the strongest economies in the world. The markets were turning, corporations had finished their cycle of cost cutting and about to start investing again, and the Fed's monetary stimulus propped up consumer demand so that output growth was looking positive for 2003, despite weaknesses in the labor markets. To what extent do you agree or disagree with this assessment?**

RM: It's true that we're not dealing in recession terms with negative rates of growth. Rather we're dealing with low rates of growth compared to previously high rates. Real recovery won't come until investment bounces back. I believe that the measures that President Bush is proposing will have an impact on investment by making it more attractive for investors to enter the equity markets.

RD: **A central component of the Bush plan is an individual income tax exclusion for dividends. What do you see as the most significant impact of this policy?**

RM: The general effect is a substantial reduction of taxes on the earnings of capital. This is going to move forces into the market. The shift in the distribution of income should increase national savings and economic growth and also—because it will not apply equally to foreigners—reduce the capital inflow and the deficit in the current account of the balance of payments. It goes part of the way to eliminating the distortion caused by double taxation of dividends. It is, however, a second-best approach.

RD: **What would a "first" best solution look like that would have had a greater and more direct impact on corporate investment and output?**

RM: The best solution, in my opinion, would be to eliminate the corporation tax. This would eliminate the double-taxation problem at its source, restore the stock market, and jump-start investment. It would also encourage small companies to incorporate and eliminate the distortion that arises from the three levels of taxation.

The corporation tax can be thought of as a tax on corporate revenue with wages exempt; i.e., it is a tax on corporate profits. Distributed corporate profits are then taxed again with the income tax. The main distortion is the corporate tax itself, not that dividends are taxed at the same rates as other income. A good part of the revenue loss from eliminating the corporation tax would be made up by increased receipt of income tax as distributed profits are increased.

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RD: **If this is, in fact, the best option, and I'm sure companies everywhere would be all for it, why didn't we see a move in this direction in Bush's economic plan?**

RM: The answer, I suppose, is politics. The corporate income tax has become a cultural icon in the antibusiness mentality that grew out of the Great Depression and World War II, and there would be strong opposition to eliminating it. There are also revenue implications.

Revenue from the corporation tax has been dwindling over time, but it is still substantial, perhaps over $100 billion. Elimination of the tax would arouse fears of larger budget deficits, largely because people would not take into account increased revenues from other taxes.

I am not a politician, but I believe a good political case could have been made not for abolishing the corporate tax in one fell swoop, but lowering it to 20%, the same rate as the capital gains tax on investments held long enough.

RD: **What potential impacts can we expect to see in response to eliminating the tax on dividends in terms of corporate finance? Could there be a direct implication for a company's growth, earnings, or financial strategy?**

RM: Well, there are several factors to consider here. First, the Bush plan should greatly reduce the penalty on equity financing as compared to debt financing, which should encourage a better corporate finance structure. In the long run, corporate earnings will be affected insofar as the tax has a macroeconomic effect in getting the economy going again and stimulating growth. But financial managers should also be aware of the short-run impacts of the tax reduction on foreign ownership of equity and the value of the U.S. dollar.

Insofar as foreigners don't get the benefit of the exclusion, it could operate to keep capital away from the U.S. markets, which will have the secondary effect of depressing the dollar. Of course if the dollar goes down, it will increase the relative dollar value of corporate profits reported in U.S. currency. Now if foreign ownership of U.S. companies becomes less attractive due to the relative penalty foreigners pay in holding U.S. securities, the balance of foreign equity holdings in a particular market or company could change and ultimately affect stock prices. In that case a company may watch its share price fall, despite meeting its earnings targets. Yet this is something that can be anticipated, understood, and explained quite effectively from an economic standpoint.

RD: **Do you anticipate that more public companies will be paying dividends or issuing shares that pay dividends in the hope that this will raise stock prices?**

RM: Corporations will do what they've always done—try to maximize the value of the corporation. They seek a balance between reinvestment of retained profits and paying out dividends. On balance, the dividend exclusion will incline corporations to pay out more dividends and be a little less inclined than before to reinvestment of profits in order to let shareholders take advantage of the lower capital gains tax rate.

RD: **Given concerns over the public debt, increased government spending and growing budget deficits (White House budget analysts are predicting the federal deficit will reach $300 billion in the next two years), and problems with long-term pension and Social Security financing, can the federal government afford to take another hit to their revenue stream? Do you see an equivalent offset in public revenues emerging from wages and corporate incomes?**

RM: By far the biggest hit to revenue comes from recession and sub-par growth. Had growth continued as in 1995-2000, we'd still have surpluses. The deficits will be 3%-4% of GDP, larger than we might like but not an immediate danger to the U.S. economy. Because the DEBT/GDP improved over the past 10 years, the U.S. has more breathing space to invest in policies to restore growth even at the expense of the deficit. To the extent that growth is increased along the lines of dynamic accounting (i.e., taking into account the potential for economic growth to increase government tax revenues), the deficit will not become a great problem.

RD: **How effective will the Bush plan to stimulate corporate investment be now that the U.S. is at war with Iraq and in the event of potential external shocks like the threat of nuclear attack from North Korea and the ongoing civil unrest in Venezuela? Furthermore, how will financial executives or investment managers plan their strategies in the current environment?**

RM: Corporations will seek to remain liquid. If the war is mercifully short, the stock market will rebound quickly. But if it is protracted out for a long time, the stock market will test new lows.

Also, further disruptions in the supply of oil could have substantial costs to U.S. industry. Under these circumstances, I think financial management and investment strategies will take an extremely cautious approach.

RD: **Now that there is a war with Iraq, both domestic and international investors will turn to traditional safe-haven assets such as U.S. treasury bills or the most stable of liquid assets, the U.S. dollar. How worried should companies be about the value of the U.S. dollar rising and the possible negative impact on the demand for U.S. goods internationally?**

RM: I don't think the U.S. needs to be worried about a dollar that is too strong. After all, the dollar lost 15% against the euro in the past year. I do think the dollar will recover somewhat against the euro but not enough to be a worry. In the long run, the main danger is dollar weakness, not strength.

RD: **Do you see President Bush's policy toward Iraq creating a distinct disadvantage for U.S. corporations abroad and ultimately the competitiveness of U.S. companies in the international marketplace?**

RM: It is probably necessary to be prepared for increased risks to U.S. corporations overseas as a consequence of heightened threats of terrorism. But I do not think the threat to corporations of terrorism is any bigger than the reality of widespread corporate malfeasance.

RD: **What should CFOs be thinking about most in terms of international financial management and protecting earnings?**

RM: They should worry most about the dollar-euro exchange rate. Companies will have to bear in mind the possibility of a dollar crisis. When the dollar starts to weaken, as it has over the past year, the large current account deficit will coincide with a substantially more unfavorable net debtor position of the U.S. Of course the U.S. economy did marvellously over the past 20 years, with high rates of growth and high rates of employment. At the same time, the U.S. is overspending its income by 3%-4% every year, and that indebtedness builds up. There is a grave defect in our international monetary architecture that will come home to haunt us in the next decade.

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The problem is endemic to it, and it is peculiar to the United States. The role of the dollar as the de facto world currency means that everyone wants to buy American assets and keep American assets in their portfolios. The impact of this lending to the U.S. has been to help create the current account deficit and build up the debtor position of the U.S. For the past 20 years, the U.S. could tolerate the deficit because it was willing to run down the creditor position it had built up earlier in the century. It was the largest net creditor in the world economy before 1980. With the current account deficits of the 1980s, however, the U.S. had by 1990 become a net debtor in the world economy. Since that time the current account deficit has been piling up at the rate of hundreds of billions of dollars (equal to the current account deficit) every year. U.S. net debt in the world economy is now $2.5 trillion to $3 trillion, getting toward 30% of GDP. At some point this is going to create a major crisis. It is an accident waiting to happen.

RD: **What advice do you have for CFOs and other financial professionals going forward in 2003?**

RM: American companies and their senior executives have been through a very bad period over the last two years, but we're, I hope, learning from it. I think we can make a blessing in disguise out of the corporate corruption by pairing it with a new kind of alertness to the importance of keeping integrity in reporting and corporate accounting. What I hope will come about, and I'm rather optimistic that it will come about, is that by the end of this year we'll be starting on a strong upward path.

We have to get past the hurdle of the Iraq war, but, after this, I would look forward to another long period of expansion—probably not quite at the level of the late 1990s but higher than average for the U.S. economy. The train of technological improvements set in place by the IT revolution is going to continue to increase productivity in every sector of life. There's also tremendous opportunity for U.S. companies across the Pacific. China is emerging as a strong new player in the world economy, a big host to foreign investment with a rapid rate of growth. The entrance of China as a major manufacturer in the world economy is going to be solidified in this coming decade, and American companies should get ready for the largest emerging market in the world. ■

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