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There Is a Free Lunch

By Richard W. Rahn
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Have you ever had a "free lunch?" A "free lunch" means the benefit you receive has no direct or indirect costs and is not a payment for a past act or a future obligation.

When Hillary, in her Christmas video, showed all of the "gifts" she was going to give us (e.g., "national health insurance," "kiddy care," etc.), she was promising to saddle us with future tax obligations, which are only "gifts" in Washington political-speak — and certainly not a free lunch for the nation.

The administration, members of Congress, and the presidential candidates are in the process of coming out with their "economic stimulus" plans to help avoid a recession or to mitigate the pain if one occurs. Rather than take this opportunity to offer a "free lunch" by removing government obstacles to a proper functioning economy, some will propose more spending and regulation because they are more interested in power than doing what is best for the citizenry.

It is important to remember that government can only "spend" by taking labor and capital resources from the private sector. To believe government can "spend" us into prosperity, you need to believe government can more efficiently manage activities than the private sector, and that government will be so efficient in its management that it will also overcome the considerable extraction costs of obtaining the additional tax revenue or borrowing to pay for the new spending. If you actually believe all that, then you have not been paying attention, and if so, as they say, I have a bridge to sell you.

During the Great Depression in the 1930s, there was a widespread belief that the government could spend its way out of the mess. It didn't work. The Depression lasted for more than a decade until World War II. Variants of "let's spend our way to prosperity" have since been tried in the U.S., Europe and other places around the world — and again have consistently failed.

The good news is there are many things the government can do that will improve the economy with almost no negatives. For instance, some tax rates are above the revenue and welfare maximizing rate, and there are many unnecessary government regulatory impediments on productive activity that should be removed.

One "free lunch" is to reduce the federal corporate tax rate from 35 percent to 25 percent. Such a rate cut will make U.S. businesses more globally competitive and increase employment growth and investment. At the same time, the rate reduction is unlikely to cause any revenue loss and may, in fact, increase total tax revenues, and here is why:

The United States now has arguably the highest corporate tax rate in the world — combined with the average of state corporate tax rates, it works out to about 40 percent. More than two dozen developed countries have cut their corporate tax rates in the last two years. Even France and Germany have lower corporate tax rates than the United States. Ireland has reduced its tax rate to only 12½ percent, which helped it to go from one of the poorest countries in Europe 20 years ago to the one with the second-highest per capita income today.

Most of the former communist countries in Central and Eastern Europe have now adopted low rate flat taxes, the most recent being Bulgaria, with a maximum corporate rate of only 10 percent.

The reasons the rest of the world have been cutting corporate tax rates is they found that lower rates bring in more revenue, and they need to have lower rates to be globally competitive. The U.S. is losing the competitiveness race, in part, because it is not tax competitive, and it will continue to lose global market share (and tax revenue) unless it cuts the corporate rate.

Those on the left — John Edwards being a notable current example — favor high corporate tax rates because they say most of the burden falls on owners of capital, even though many economists have long disputed this. The U.S. Treasury released a paper last month by Professor William Gentry of Williams College that provides additional evidence it is probably labor (workers) who suffer most because of the corporate tax.

Think about it for a moment. If you are a businessman with a product that is sold globally (as most are these days), to remain competitive you will either put your business in a country with a low corporate tax rate, or if you operate in the U.S. you will need to pay your workers less in order to pay the high U.S. corporate rate.

The evidence is now so overwhelming that the high U.S. corporate tax rate is damaging the economy that even Charles Rangel, the liberal Democrat Chairman of the House of Representatives' tax writing committee, has proposed reducing the rate.

Additional good news is the International Monetary Fund, not noted for advocating lower taxes, has just published a new paper showing "how tax rate cuts can increase revenues by improving tax compliance." The Congressional Joint Tax Committee underestimated tax revenue after the Reagan and Bush income tax rate cuts and the Carter, Reagan, Clinton and Bush capital-gains tax

rate cuts because its models did not adequately measure constructive taxpayer behavioral response to rate cuts.

Recent evidence from around the world now shows this behavioral response is stronger than many in the old economic establishment believed, which means that many high marginal tax rates on labor and capital can be cut with little or no revenue loss over the long run.

Those candidates wishing to pander to the economically ignorant will push for more government spending and higher tax rates on business and "the rich." Those responsibly seeking to stimulate and improve the economy will do so by advocating such things as cutting the corporate tax rate, indexing the basis of capital gains for inflation and increasing business expensing for depreciation.

Such changes, while not politically sexy, are a true "free lunch."

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