The Washington Times May 2, 2017

Why the Revenuers are Always Wrong

By Richard W. Rahn

HIGH-TAX ADVOCATES FAIL TO ACKNOWLEDGE THAT TAX CUTS STIMULATE GROWTH

If you were really hungry and given the choice of half of an eight-inch pizza or a third of a twelve-inch pizza, which would you choose? Already, the normal group of know-nothings among the political class and the press are proclaiming that President Trump's proposed reduction in the corporate tax rate will only benefit the rich. The safe bet is all those folks are wrong, once again.

Those who view the world in static rather than dynamic terms, including some of the official revenue-estimating offices, claim that reducing the tax rate on a company that made a $100 million profit from the current 35 percent to the proposed 15 percent will cost the U.S. Treasury $20 million. That statement is only true if the tax change was made retroactive for last year's income. The wiser person understands that there are no constants, perhaps with the exception of the speed of light. When everything is a variable, including time, first-order observations are usually at least in part wrong.

Newtonian physics works perfectly well for most every day calculations — i.e., the force needed to move a given mass X distance at Y velocity. But as the number of relevant variables and the precision desired increases beyond five decimal points, eventually chaos theory takes over. Good pool players can calculate with great accuracy the return angle of a pool ball when the edges of the pool table are straight lines, but the task is nearly impossible if one end of the pool table is curved. You may be familiar with the concept about how the flap of a butterfly wing in Brazil last year will have a large or small but unknowable effect on the temperature in New York at high noon on Jan. 19, 2042. Every action, no matter how small, over time affects everything else in unpredictable ways.

Forecast models with large numbers of variables become more and more inaccurate the longer the time period, because even very small erroneous specifications of any variable will normally get magnified over time, eventually leading to a chaotic state with meaningless results. Models that claim to forecast entire economic systems (which depend on accurately predicting human behavior) or climate systems over long periods of time are close to useless. But models that have fewer important variables — operating over relatively short periods of time — enable us to direct a rocket to the space station.

There is a rule in Congress that require any tax cut to be paid for with either some other tax increase or expenditure cut. This simple rule fails to distinguish tax revenues from tax rates and disregards time periods. The question with the proposed corporate tax rate cut should be: How long will it take for it to pay for itself? Non-financial corporations over time average about a 9 percent return on capital investment before tax. A tax rate cut will reduce the tax penalty on new investment and job creation, thus improving incentives for additional economic output.

In the short run, the tax rate cut will reduce the revenue to government, requiring the government to borrow more. Currently, the government pays about 2 percent on average for the funds it borrows. If a company can generate (creating new wealth) 9 percent on the money it saves in the tax cut, which only costs the Treasury 2 percent, the tax rate cut is a good investment for the individual firm, its workers and the economy. If you do the math, the payback time, assuming principal payments from the "now bigger" company is perhaps six years, it then becomes a revenue gainer — the miracle of compound interest.

Because of space limitation, I have left out many other important variables. At a 15 percent rate, the United States will become more internationally competitive, attracting more foreign capital, and cause U.S. companies to bring back their foreign earnings on which they will now pay tax. The lower corporate tax rate also increases the incentive for people to start new businesses. Some companies will choose not to reinvest all of their tax savings, and will either invest in other firms or increase their dividend payouts. Most dividends go to higher earners, or pension funds, where most of it is reinvested rather than consumed.

There was a great argument about whether the Reagan tax cuts paid for themselves as a result of a much larger economy, or added to the long-term deficit. The best evidence is the Reagan tax cuts probably took about seven years to "pay for" themselves in terms of government revenues, but in the meantime there was a huge growth in jobs and real wages — a clear win-win.

It is not possible to know with precision all of the effects of any particular tax change, but treating business tax changes as a change in the cost of investment, as companies do, gives a good approximation of the benefits and costs. My bet is that a decade from now, even though the government slice of the economic pizza pie is smaller as a result of the proposed tax rate cuts, almost all Americans will be enjoying more economic pizza.

Richard W. Rahn is chairman of Improbable Success Productions and on the board of the American Council for Capital Formation

http://www.washingtontimes.com/news/2017/may/1/tax-cuts-stimulate-growth/

Copyright © 2017 The Washington Times LLC. All rights reserved.