

REAL CHANGE

From the World That Fails to the World That Works

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CHAPTER ELEVEN

Real Change to Achieve Enduring Prosperity for American Workers

IF EVERYONE WHO WORRIES about American jobs and American prosperity understood one fact, we would have a totally different and much improved national economic policy. That fact is: geese can fly.

Remember the goose that laid the golden egg? For America, that goose has been a free market economy that encourages entrepreneurs—using science, technology, and stunning increases in productivity—to create wealth that spreads throughout society.

George Washington, Benjamin Franklin, Thomas Jefferson, and Alexander Hamilton all understood this fact. They knew why America prospered, and they knew that knowledge and money can move around the world. Hamilton, for instance, studied Adam Smith's *Wealth of Nations* and worked to attract Dutch savings to fund America's national debt. Washington studied innovation in farming and husbandry in Europe and applied it to his farm at Mount Vernon.

Franklin was a world-renowned scientist and a member of the Royal Society in Great Britain. He routinely communicated with British, French, and other scientists.

It was because of their belief in the power of science and the application of knowledge to creating wealth that the Founders wrote the Patent Office into the Constitution. For more than two hundred years, their free market, pro-entrepreneur, pro-knowledge model has made America a leader in creating jobs, prosperity, and wealth for the many.

Now there are two real threats to our economic future. The first is the liberal government model of high taxes, complex regulations, expensive and destabilizing lawsuits, and rule by bureaucracies that fail to perform (especially in education). The second is the desire to hide from world competition by closing markets and “protecting” current jobs and investment at the expense of the jobs of the future. These two threats could combine to convince the golden goose to fly to other countries and create jobs and wealth there.

We have seen case after case of destructive American policies driving business and jobs out of the United States:

- ★ Tax policy has driven the reinsurance business out of the country.
- ★ Litigation threats are a major factor moving financial sector jobs from New York to London.
- ★ Regulatory and tax burdens have blocked new gasoline refineries from being built in the United States for three decades.
- ★ Energy policy, taxes, and regulations are driving chemical industry jobs overseas.

Bad policies drive entrepreneurs, knowledge, and capital away and kill American jobs while trying to “protect” them. Consider the per-

verse effect of limiting H-1B visas, which allow highly skilled foreign workers to live and work in the United States. Existing jobs are not protected. Future jobs are driven out of the United States, as companies hire exactly the same people to produce wealth in Canada, India, or China.

In 1960 Ghana had the same per capita income as South Korea. Today South Korea is the twelfth-wealthiest nation in the world while Ghana sits at number 100. Why? Because Ghana followed a socialist model while South Korea followed a free market model.

Forty years ago the leading Irish export was young people leaving for jobs outside the country. Today Ireland has a higher per capita income than Germany, and 160,000 temporary workers from Eastern Europe live in Ireland. As a result of a generation of cutting taxes, reforming education, investing in infrastructure, working hard, and reshaping its government to be friendly to foreign investment, the German Bundesbank now projects that Ireland is on its way to becoming the wealthiest country in Europe per capita. In fact, European Union bureaucrats in Brussels complained that Irish taxes were too low and that they were therefore cheating, which meant that in order to slow down to the rest of Europe's rate Ireland needed to raise taxes.

Bad policies lead to bad outcomes. But the reverse is true as well. If we have the right policies, policies that expand our free market system, we can create better outcomes than we can imagine.

LONDON TO REPLACE NEW YORK?

America's ability to win, and not just compete, in the global economy depends in part on our having the world's most efficient capital markets. We need substantial reforms in this area if America is to be the

most successful economy in the world and the best source of high-paying jobs with enough economic growth to sustain the Baby Boomers and their children when they retire.

There are several indications that America is becoming a less desirable place to do business. In today's global economy, companies have increasingly attractive alternatives of where to locate and where to seek capital financing.

- ★ Last year, the U.S. financial exchanges attracted barely one-third of the volume of global initial public offerings (IPOs) that they had in 2001, while the share by European exchanges expanded by 30 percent over the same period.
- ★ A 2005 press report by the London Stock Exchange attributed one reason for its success to the fact that “about 38 percent of the international companies surveyed said they had considered floating in the United States. Of those, 90 percent said the onerous demands of the new Sarbanes-Oxley corporate governance law had made London listing more attractive.”
- ★ In April 2007, Europe's financial exchanges (including the Russian and Eastern European markets) surpassed those of the U.S. in stock market value for the first time since World War I.
- ★ Recently, an investment bank and institutional securities firm in Minneapolis reported that companies exited public markets at a 73 percent higher rate last year.
- ★ International middle market firm Piper Jaffrey showed that in 2006 “239 public companies either were sold to strategic buyers . . . or to private-equity groups” and in 2005 “138 companies left the public roster.”
- ★ Requirements that public company boards contain a majority of independent directors could have a chilling effect on risk-taking,

a driver of economic progress. Reducing these unintended costs of recent regulatory reform will be essential for America to retain its competitive edge.

The 2002 Sarbanes–Oxley Act, which adds massive new reams of accounting red tape for businesses, clearly created a regulatory environment that has driven IPOs out of the United States. Furthermore, the legislation is leading public companies to delist from the stock market in order to avoid red tape (and potential criminal penalties). Following the law of unintended consequences, the Sarbanes–Oxley Act effectively drives businesses to be less accountable than they were before and has done vastly more damage to the American economy than the corporate accounting scandals it was supposed to reform. It has had a substantial negative effect on New York as a financial center and has been a big asset for London. It is a wound inflicted by Congress on the American economy.

A report by the McKinsey consulting firm commissioned by New York City mayor Michael Bloomberg in early 2007 warned that London could replace New York as the world's leading financial center. This danger has very serious implications for the American economy. The financial sector is the third-largest sector of the American economy, provides 8 percent of our gross domestic product, and has been our third-fastest-growing sector. It is the fastest-growing sector in New York City, where it comprises 15 percent of the economy. If London replaces New York as the center of world financial activities, it could mean a loss of \$15 billion to \$30 billion and 30,000 to 60,000 jobs.

It's not a matter of what London is doing right. The issue is what America is doing wrong. American policies are so destructive that London is competitive even though the cost of living there is actually

much steeper than in New York. Substantial reform will be required if New York is to remain the financial capital of the world.

One way in which we harm our own financial sector is our immigration policy. Our policy makes it much harder to attract an international work force. We should address this by creating enough special work visas for high-value workers who bring specialized education, entrepreneurial talent, or capital that will grow the American economy and make America a more prosperous country.

The government currently caps the number of H-1B visas at 65,000, with an additional 20,000 allowed for “high-value” immigrants with degrees from American universities. Last year, 123,000 applications (for only 85,000 slots) were received in the first two days of the application period. Our economy depends on these workers, not only because they meet the demands of some of our most successful companies, but also because many of these workers come here and start some of our most successful companies. Intel, eBay, Yahoo, and Google are a few examples.

To remain competitive we need to massively expand the freedom for high-value workers to come to the United States and contribute to the growth of our economy. To determine who should get visas, we ought to establish a point system that takes into account a combination of advanced degrees, technical skills, and experience in fields that require these kinds of workers to help grow our economy.

A COMPETITIVE DISADVANTAGE: RUNAWAY LAWSUITS AND RED TAPE

The advocate of quality, W. Edwards Deming, once warned that litigation was one of the greatest threats to the American economy.

Today, the law is being changed from an instrument of justice into an instrument of extortion and redistribution. Americans are learning to treat litigation as a lottery, to sue rather than settle, and to turn American civil life into one of conflict and suspicion. Litigation reform needs to address several factors:

- ★ making arbitration preferable to litigation
- ★ making losers pay
- ★ prohibiting law firms from bringing class-action lawsuits
- ★ banning lawyers from advertising
- ★ fixing the fraud and abuse in mass tort litigation
- ★ reforming securities litigation

The American litigation system is one more factor helping London take business from America. Why invest it in America just so a trial lawyer can take your wealth from you? Almost every other country in the world has a more benign legal system. Litigation risks increasingly drive companies and investors out of the United States and kill American jobs.

Litigation reform is about more than lawsuits. We have also to rein in state attorneys general. The blackmail model championed by New York's former attorney general (and now governor) Eliot Spitzer, which mugs companies without going to court, is a job killer. These practices must be stopped. The Constitution is clear that the federal government sets the framework for the national economy. Congress and the executive branch have a constitutional duty to protect that role from encroachment by state attorneys general searching for headlines.

In the middle of the challenge to New York's historic importance as a financial center, the liberal answer in Congress has been to try to

increase taxes on the financial community. We should oppose such tax increases. Legislation has been introduced that would raise taxes on publicly held private equity firms, taxing them at a corporate rate rather than a capital gains rate. Private equity firms, whether held privately or publicly, generally require clients—investing institutions such as university endowments or wealthy individuals—to have a large investment of millions of dollars. So the only way for the average middle-class investor to get a piece of the private equity pie, besides winning the lottery, is to buy cheap shares of a publicly held private equity firm. However, if going public means higher taxes, private equity firms will have no incentive to go public and the average investor will be locked out of those companies. Denying the best profit opportunities to all but the very rich hardly seems like leveling the playing field.

Raising taxes on publicly traded private equity firms might not keep these firms from going public—it might just make them go public overseas. EU firms have a 26 percent tax rate. If Congress, in the name of “fairness,” raises tax rates on private equity to 35 percent, it could drive new fund formation—along with jobs—overseas.

ABOLISH THE CAPITAL GAINS TAX

As an example of how far behind economic reality American politicians are, consider the analytical gap between all three leading Democratic presidential candidates—who advocate an increase in the capital gains tax (the tax on investment income)—and the views of President John F. Kennedy and former Federal Reserve chairman Alan Greenspan:

“The tax on capital gains directly affects investment decisions, the mobility and flow of risk capital . . . the ease or difficulty experienced

by new ventures in obtaining capital, and thereby the strength and potential for growth in the economy.”

—John F. Kennedy, 1963

“[The] major impact [of a capital gains tax], as best I can judge, is to impede entrepreneurial activity and capital formation. . . . I [have] argued that the appropriate capital gains tax rate [is] zero.”

—Alan Greenspan, 1997

The American people agree with Kennedy and Greenspan: taxing investment is destructive. In an American Solutions survey in 2007, Americans favored abolishing the capital gains tax by 48 percent to 41 percent. That support has grown despite the fact that no candidate and no political party has made a consistent argument for getting rid of it.

The American people are way ahead of the politicians because they understand what the capital gains tax is: a tax on productivity and on their personal savings. More and more, the American people understand the importance of savings and productivity for their own livelihood. An October 2007 editorial in the *Wall Street Journal* explained why:

Recent surveys indicate that roughly 52 percent of American adults own stock in some form, and last year 8.5 million of these investors paid a capital gains tax. The value of those assets will decline if capital gains taxes go up because financial markets instantly capitalize higher taxes on stock profits into lower stock prices.

We saw this effect in May 2003 after the passage of President Bush’s investment tax cuts. An analysis by the investment advisory firm Strategas shows that stock values rose by 10.3 percent in the following weeks, and over the last four years the net worth of Americans’ stock holdings has increased by some \$6.2 trillion. Economic growth was the largest

driver of stock prices, to be sure, but a higher after-tax return on capital also played a role.

Just as the Founding Fathers would have predicted, the capital gains from increased productivity actually led to increased prosperity for virtually all Americans. The editorial cited a study by Gary Robbins, a former Treasury Department economist, who found that for the period 1946 to 1998, about “90 percent of the returns to capital investment accrued to workers in the form of higher wages.”

Ironically, tax increases on productivity actually led to a decline in government revenues, a now familiar dynamic:

For the past forty years, capital gains tax increases have been associated with a decline in tax revenues. Rate cuts have generated more tax collections. One reason is that higher rates give investors an incentive to hold their assets to avoid paying the tax. The capital gains rate was last raised in 1986. Revenues from the tax tripled in the year before the increase, as investors cashed out of assets before the window of the lower tax rate slammed shut. But in each of the five years after the rate jumped to 28 percent from 20 percent, capital gains revenues remained below the pre-1986 level, according to a study by the National Chamber of Commerce Foundation.

Conversely, the 1997 capital gains tax cut had a stock market unlocking effect. Congress’s consistently mistaken Joint Committee on Taxation predicted that the government would collect \$195 billion from 1997 to 1999 from capital gains payments. The actual amount was \$279 billion. In other words, the lower tax rate raised \$84 billion more than expected—which is one reason the late 1990s produced budget surpluses. Most recently... the 2003 tax cut produced a dou-

bling of tax receipts to \$97 billion in 2005 from \$47 billion in 2002. That's twice what Congress predicted.

MOVE TO A ONE-PAGE OPTIONAL FLAT TAX

According to the American Solutions research, four out of every five Americans would like to have the option of a one-page tax form with a single tax rate. This concept of an optional flat tax was developed by Steve Forbes when his flat tax campaign was undermined by criticisms that it would take away popular tax breaks. Steve Forbes and Stephen Moore have both proposed giving American taxpayers an opportunity to choose simplicity versus complexity and a single rate over a lot of deductions. They call it the free choice flat tax, and it's an idea whose time has come.

The Free Choice Flat Tax

All workers and corporations would have the freedom to choose each year to file their income taxes either under the new free choice flat tax option or under the current U.S. income tax code. Anyone who strongly favors a deduction or credit under the federal government's current complex income tax system would have the choice to keep filing that way.

Rhode Island adopted an optional flat tax, and lawmakers there expect that it will make the state more competitive with neighboring states in attracting new business and entrepreneurs who create jobs.

Tax simplicity—by saving time, relieving businesses from record keeping, and relieving the budget from accountants' and attorneys' fees—is even more important than a lower tax bill. Many people will actually pay a little more in taxes in return for certainty and simplicity.

They feel they save so much in record keeping and compliance, which costs an estimated \$200 billion a year, that they are thrilled by the optional flat tax.

The free choice flat tax option would apply one single tax rate of 17 percent to all individual and corporate taxpayers. It would also include a standard exemption of \$13,200 for each adult (\$26,400 for a married couple) and a \$4,000 exemption for each child or dependent. The current \$1,000 tax credit for each child age sixteen or younger would also apply, as would the current earned income tax credit (EITC). This would mean no federal income tax on the first \$46,165 in income for a family of four.

The free choice flat tax option eliminates all loopholes that could allow higher-income people to avoid paying taxes. But the personal exemptions, the child tax credit, and the EITC would free 42 percent of taxpayers—all from low- and moderate-income households—from paying federal income taxes at all. Many tax filers would receive net tax rebates from the child tax credit and EITC.

The free choice flat tax would eliminate the death tax, the capital gains tax, and the alternative minimum tax. There would be no tax on retirement benefits or on Social Security benefits. There would be no tax on dividends because corporations would have already paid tax on that income at the corporate level.

Filing under the free choice flat tax option would require just one form on one sheet of paper. This would save taxpayers billions each year in costs of record keeping, paying for tax advice, and filling out complicated tax returns, as well as countless hours of aggravation and worry.

The free choice flat tax option is specifically designed so that no person or corporation pays more in taxes than they pay under the current system. In fact, the free choice flat tax option is intentionally

designed so taxpayers will pay lower federal income taxes than they pay under the current system. When additional revenues from higher economic growth are counted, then the free choice flat tax option is expected to be revenue neutral, raising as much revenue overall as the current tax system. The free choice flat tax could be adopted immediately at little risk to the taxpayer or the government.

The Fair Tax

There is another tax system, which would involve a lot more change and a bigger risk. Yet it is also gaining momentum as people grow tired of the current mess. It's called the fair tax.

There is no more passionate group of tax supporters in America than the advocates of the fair tax. They propose replacing the current taxes on income with a tax on consumption (basically replacing income tax and the IRS with a national sales tax), arguing that the world market has placed America at a considerable disadvantage. Other countries use a value-added tax, which can be deducted on exports and applied to imports. Under the various international trade agreements, income taxes (including the Social Security tax) cannot be deducted from exports or applied to imports.

The fair tax idea is a much bigger innovation than an optional flat tax on income. However, it faces three big challenges:

First, people must learn how their personal spending habits would be affected. During every survey that portrays the fair tax as a consumption tax, people become cautious and suspicious. Americans would have to be convinced that they gain more from abolishing the income and the Social Security tax than they lose in the consumption tax.

Second, we would have to amend the Constitution to remove the right to impose a personal income tax. I would never want Congress

to have an ability to tax both your income and your spending. We all know they would if they could.

Lastly, enforcement is required, because people will always be tempted to find a way not to pay. While the Internal Revenue Service would not be looking at your income tax return, it would be looking at every business as an indirect tax collector on every sale. This nuance must be more accurately explained by the fair tax supporters.

The fair tax is worth studying and debating, but for the reasons listed above, it will require a lot of work to be adopted.

However, we could do something to start phasing in a fair tax approach now. Nine states survive perfectly well with no state income tax. These include large states such as Texas and Florida and the very prosperous state of Tennessee. Studies show the states without income taxes have higher economic growth and more rapid growth in jobs and personal income.

The other forty-one states could move toward phasing out their state income taxes as well. Part of the lost revenue can be made up by increasing the state sales tax by a couple of points. The rest can be made up by restraining the growth of state spending to increase no more than the rate of population growth plus inflation. A study by Steve Moore and Peter Ferrara argues that state income taxes can be phased out in fewer than ten years through this formula.

ENCOURAGE BUSINESS JOB GROWTH IN AMERICA

As Kevin Hassett of the American Enterprise Institute has suggested, we should abolish the capital gains tax for businesses as well as for individuals. We also need a tax break for corporations that keep their headquarters in the United States. It is in our interest to keep corporate

management, creativity, and power centers in the United States. Every company willing to do that should receive a substantial tax break.

We should create a tax system in which every investment in new equipment can be written off in one year. We want American workers to have the world's best equipment and best new technology so they can be the world's most productive. It is self-destructive to have a depreciation code that lasts longer than the equipment depreciating.

The research and development tax credit needs to be permanent to maximize investment in new science and new technology. When businesses have to wait for Congress to extend the tax credit to make continuing research and development investments, time and money are wasted.

The double taxation of dividends should be ended as well so the bias against investment is ended. Beyond the tax code, American business will need an enormous amount of capital to grow as rapidly as needed in the next two generations as our economy takes advantage of dramatic scientific and technological innovation.

Fortunately, there is a reform that can help younger Americans grow a dramatically bigger economy, with better take-home pay and more accumulation of resources for their own retirement. This can be achieved by giving every American the choice to create a personal Social Security savings account, which I describe more fully in the next chapter.