CAN CAPITALISM AND THE AMERICAN DREAM SURVIVE ?

NORTHWOOD UNIVERSITY

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Can Capitalism and the American Dream Survive?

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Executive Summary

This paper is a critical analysis of U.S. monetary, fiscal and regulatory policy from the early 1900's to date. In section one: "Introduction, the Market Process and Government Intervention" the authors examine the economic, political and philosophical underpinnings of American greatness and introduce their concerns with improper government fiscal, regulatory and monetary policy.

The second section of this paper examines the growth of government at the local, state and federal level from 1900 to 2010. The data shows a clear change in the size, scope, role and focus of government at all levels. As measured by GDP, combined local and state government in 1902 was more than twice the size of the federal government, a clear validation of the "Principle of Federalism" more than 125 years after the signing of the Declaration of Independence. It is also important to note that government consumes roughly six times the amount of U.S. GDP in 2010 than it did in 1902.

The United States is the largest and most successful economy in human history, yet if we are to avoid the decline of capitalism predicted by famed economist Joseph A. Schumpeter, we must reverse the trends outlined with empirical data in section three. Finally, suggestions for the reform and advancement of the U.S. economy are outlined in the paper's conclusion.

Special thanks to Mr. Doug Pergament and Dr. David Rausch for their input and feedback.

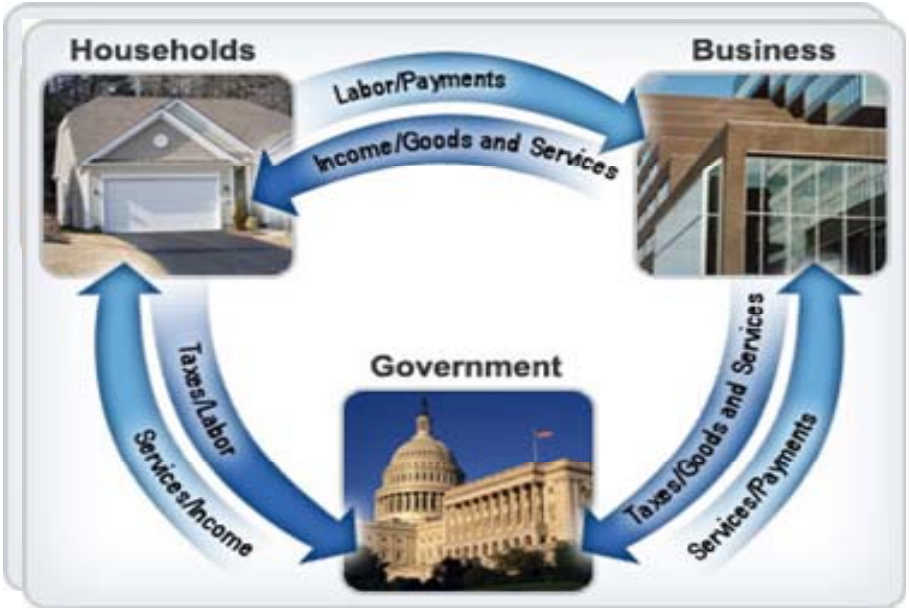
Section I: Introduction, the Market Process and Government Intervention

America is now in her fourth century of existence because Americans have protected and embraced the traditions and structure of her free society. At Northwood University we believe it is our **duty** to defend and promote the freedoms so many Americans have given their lives to protect, freedoms which have ensured the prosperity and standard of living of this great country and many others around the world.

In fact, Thomas Jefferson wrote more than 200 years ago, "The most effectual means of preventing the perversion of power into tyranny are to illuminate so far as possible the minds of the people. If a nation expects to be ignorant and free, it expects what never was and never will be."

The research contained in this paper is dedicated to the challenge made by Jefferson. It is about freedom, vigilance and the fight against ignorance across this country and around the world. It is a reflection on the economic history of the United States, especially the twentieth century to date. The paper is an unapologetic, data-driven defense of the values, ethics, traditions and principles that are the American competitive free enterprise system…American Capitalism. It reflects our belief that it is part of America's DNA to create, prosper, and lead in commerce and volunteerism. To do so, Americans must understand the positive role capitalism has played in the founding and history of this great nation and its role in human progress around the world. We can never forget that the vast majority of American jobs have been created by a free and mostly ethical business community driven by customer needs and the profit motive (see Chart 1).

Chart 1: The Circular Flow Model



Source: IRS.GOV

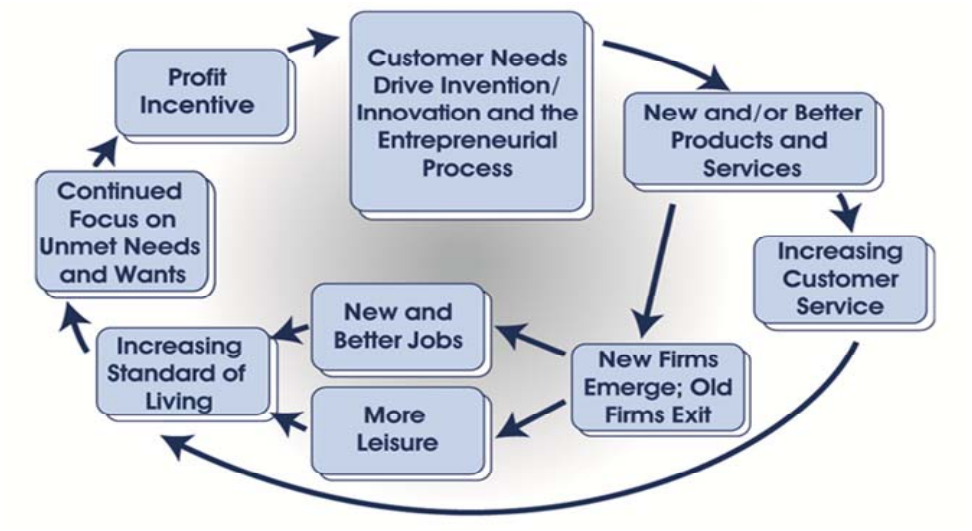
We must remember that businesses, along with employees and households, pay the taxes that make the funding of government possible, while charity and volunteerism exist at exceptional levels in American due to the blessings of a productive economy. We wrote this paper to celebrate the success of free people, to voice our concern with the state of the American economy, and to improve the general public's understanding of capitalism.

In his monumental work *Capitalism, Socialism and Democracy* (1947), the famed Harvard economist Joseph A. Schumpeter asked the question "Can Capitalism Survive?" His answer was "no", but unlike the Marxists and Socialist of his day, Schumpeter did not believe capitalism would be destroyed by its enemies (the proletariat). Schumpeter believed that capitalism would be destroyed by ignorance, envy and jealousy. It would be destroyed by an intellectual class who made its living by attacking the very system of freedom, private property, competition and wealth generation that made their existence possible. In *Capitalism, Socialism and Democracy* Schumpeter praises capitalism and the productivity, wealth, invention and innovation generated by the entrepreneurial process under capitalism. Schumpeter believes capitalism will ultimately fall because business leaders and others would be unable to defend the system against the attacks of the intellectual class and the politicians. We believe Schumpeter's prediction is not inevitable; business leaders armed with proper knowledge will prove it to be wrong. We believe the data in this report will be of great value to this end.

Today, in country after country, leaders fill their speeches with rhetoric praising freedom and free enterprise while back in their offices their actions increase the influence and reach of the state over individual behavior and the economy. Rhetoric is a very powerful tool that must be followed by action. The great challenge before us is to educate our business leaders and politicians and the public so we can ensure our leaders' rhetoric matches their actions and leads to sensible policies that protect individual freedom…this will not be easy. "Can Capitalism and the American Dream Survive?" contains ideas that have helped humans prosper since before the birth of Christ and are especially relevant today when the world is facing many challenges. We believe that a better understanding of these ideas can restore the principles of individual liberty, political and economic freedom, low taxes, limited government, the rule of law, entrepreneurship, and ultimately the restoration of the American Dream!

The noted French author and playwright Victor Hugo once said, "Nothing is more powerful than an idea whose time has come." We believe Victor Hugo was absolutely right. Ideas can change the course of the history of a person, a community, a company, a country, or the world. History shows us that ideas have the most profound, productive, and lasting results when they are allowed to: a) germinate, b) be tested, and c) succeed or fail based on the collective judgment of a free and moral society (see Chart 2).

Chart 2: Economic Cycle of Human Progress



Sources: Myths of Rich and Poor and *When We Are Free*

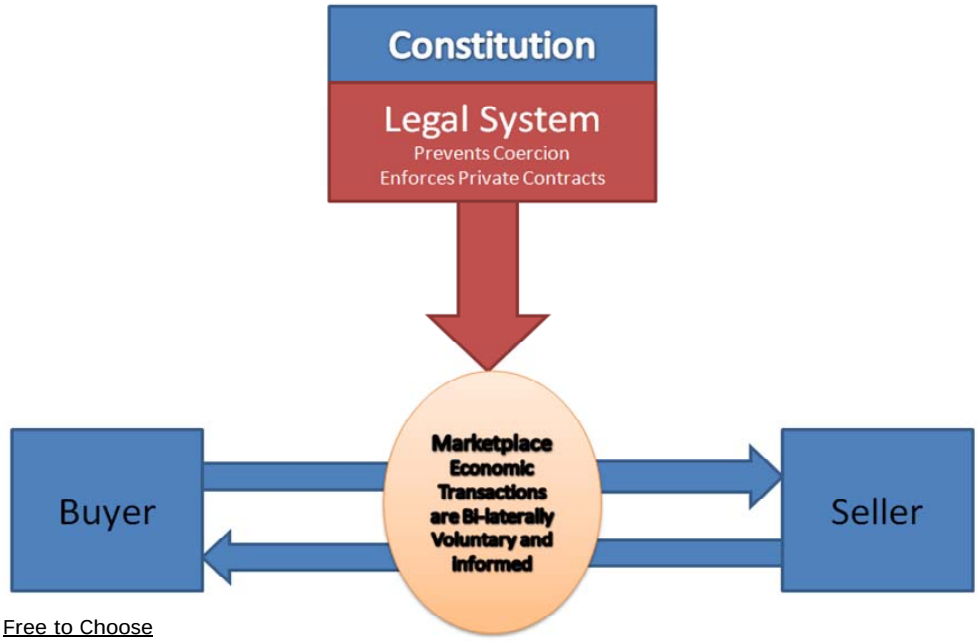
The vast majority of the business history of the United States validates this point. In just over 100 years, America went from being a country whose survival was anything but certain to the world's largest, wealthiest and most productive economy by 1900. The entrepreneur, operating in a largely free and open economy, drove America's growth with their ideas and their inventions and innovations. Entrepreneurs created the products, services, and companies that made America the envy of the world. Men of ambition learned that to compete and prosper in the American competitive free enterprise system, a business needed to: satisfy their customer's needs; provide products or services that were high quality, price competitive, and timely; and finally turn a profit. These entrepreneurs did not look to the government for favors and in return operated in a climate where government consumed much less of GDP (just over 7 percent) than it does today (greater than 40 percent). In the 1800s and much of the 1900s, companies that produced ineffective or obsolete services went out of business and were replaced with new and innovative companies that drove change and enhanced human progress. These businesses created high paying jobs and an enhanced everyone's standard of living. As an example, only one company remains in the Dow Jones Industrial Average from the original 30 when the index was started in 1890. If one compares the Fortune 100 companies of 1900, we would find that only three companies remain in the Fortune 100 list of 2010. Companies commanding the heights of the American economy in 1900 consisted of matchbook manufacturers, railroad companies, and mining companies. Today's Fortune 100 is occupied by companies that produce jet airplanes that can take us from coast to coast in a matter of hours, that produce biomedical technology that has helped to expand life expectancy from roughly 46 years to more than 80 years in just over a century, and telecommunications companies that produce devices that send a picture, a message, or the human voice around the world in a matter of seconds. And as these companies increase our nation's wealth, they continually lower the costs to the average consumer. A three minute

coast-to-coast telephone call in 2010 costs less than 1/1400 of the price it did in 1900. When adjusting for inflation a base model 2010 Ford Focus costs 71 percent of the cost of a 1908 Ford Model-T and is a dramatically better automobile.

The free enterprise system of voluntary trade and peaceful competition among buyers and sellers enables individuals the latitude and liberty to make their own choices as consumers and producers. Market prices serve both as a network of information to coordinate the actions of billions of people in the global system of division of labor, and as the incentives for people to apply themselves in creative and productive ways guided by the hope of profits and the avoidance of losses.

But the functioning of the competitive market order is dependent upon a legal system of private property rights, enforcement of contracts, and an impartial rule of law that recognizes, respects and protects each individual's right to his life, liberty and honestly acquired property. In the United States, the foundation of this legal system is the Constitution created to delineate and limit government so as to ensure the protection of the people's liberty – including their economic freedom (see Chart 3).

Chart 3: The Rule of Law and the Market



Source: Free to Choose

However, excessive government policy can distort a free economy leaving its citizens less well off. The effects of inflationary monetary policy of the U.S. Federal Reserve Bank and improper fiscal policy enacted by Congress are outlined below.

Inflation is an increase in the quantity of money that brings about a rise in the level of prices throughout the economy. Money serves as the market's *medium of exchange* to facilitate

transactions between buyers and sellers. It also functions as a *unit of account* enabling relatively easy *economic calculation* of profit and loss among the many goods and services bought and sold on the market. And it is normally used as a *store of value*, a commodity of relatively stable and predictable value that may be held for purposes of future transactions and investments.

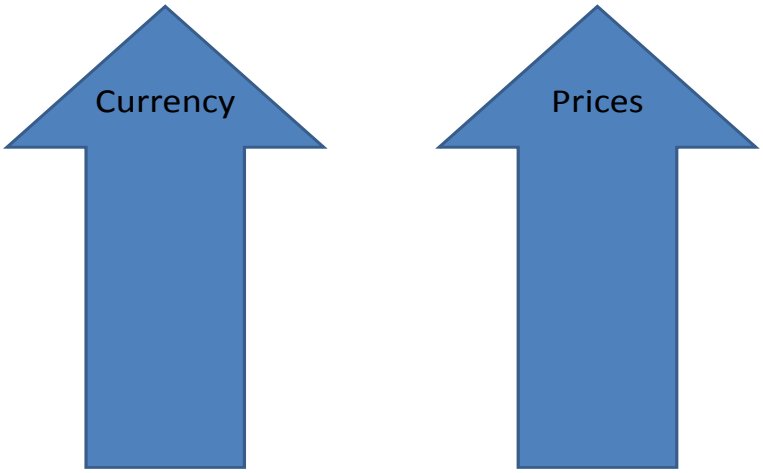
For millennia gold and silver were the market-chosen media of exchange, but in modern times governments have taken over monopoly control of money in the form of *paper, or fiat, currencies*. Governments, and their central banks, have arbitrarily increased the supply of money to fund government budget deficits, to attempt to artificially stimulate investment and spending, and to dilute the real value of their debts through rising prices that reduce the purchasing power of every unit of money held in people's pockets.

Some have referred to inflation as a *hidden tax* that enables governments to extract the income and resources of people in society without the direct knowledge and approval of the citizenry. Inflation's perverse and harmful affects also arise from its *non-neutral* impact, i.e., that prices never rise proportionally or at the same time during a monetary expansion. The created money is first injected and spent at some point in the market and then spreads out to the rest of the economy like ripples in a pond from the epicenter where a pebble has hit the surface of the water. It arbitrarily and often unpredictably makes some people better off, while making many people worse off. It is also the cause of the business cycle – economic booms and busts. The newly created money is injected in the banking system, with a resulting distortion of interest rates and imbalances between savings and investment. We are concerned about future inflation and greater economic instability due to the more than $2 trillion of liquidity the Federal Reserve has injected into the U.S. economy since late 2008 in the name of quantitative easing.

For decades during the 1800s the price of items from tobacco and cotton to wheat and iron stayed constant because money was a store of value under a bi-metallic U.S. monetary system of gold and silver. A recent conversation with a member of the "greatest generation" gave us pause to question U.S. monetary policy in his lifetime and the concern we face regarding U.S. and global inflation. The 86-year old man recalled that in 1940 the Cleveland Plain Dealer Newspaper was $.03 for the daily and $.10 for the Sunday edition, an adult ticket for a double feature movie at the local cinema was $.25, a double scoop ice cream cone was $.05, hamburger was $.15 a pound, bread was $.08 a loaf and a Baby Ruth candy bar was $.05 or three for $.10.

Standard Oil founder John D. Rockefeller died in 1937 and had amassed a fortune of $1.4 billion [1.53 percent of 1937 U.S. GDP] at his passing. Forbes Magazine contends that after adjusting Mr. Rockefeller's fortune for inflation and economic growth, he would have been worth as much as $663 billion in 2007 inflation adjusted dollars. Based on the U.S. Consumer Price Index, the 2010 U.S. dollar purchases roughly 1/15 of what a 1940 dollar purchased or it would take just over $1,500 in 2010 to purchase what $100 purchased in 1940. The U.S. dollar today has the purchasing power of roughly 1/24 of a dollar in 1900. The dollar as a store of value for the world is coming into question today as a result of U.S. Federal Reserve Bank quantitative easing and our growing national debt (see Chart 4).

Chart 4: Inflation



Source: Free to Choose

The U.S. national debt can be traced all the way back to the birth of this great nation in 1776. Due to the massive amount of debt accumulated by the federal government over the last 30 years, the cumulative U.S. federal debt prior to the 1940's barely registers in comparison. Furthermore, from 1776 to 1981, a period of 206 years, the U.S. Federal government accumulated just under $1 trillion debt. From 1981 to today, a 30 year period, the national debt ballooned from $1 trillion to more than $15.2 trillion. The federal government's dependency on leverage has only worsened in the last few years. At the end of the 2004 fiscal year the U.S. national debt was $7.4 trillion, which means with the current national debt north of $15.2 trillion, the national debt has more than doubled in the last seven years. The U.S. national debt can be defined as all debt owed by the U.S. federal government. It is divided into *Public Debt* (currently $10.48 trillion) which is debt owned by individuals, institutions, or other countries and *Private Debt* (currently $4.76 trillion) which is debt owned by the federal government itself, often referred to as intergovernmental holdings.

Concerns over this debt crisis came to a head last August as the U.S. came close to surpassing its legal debt limit. Though Congress took action to raise the debt limit and make minor cuts to the federal budget, thus avoiding default, it was not enough to avoid a credit rating downgrade. The U.S. lost its AAA credit rating for the first time in its history and still faces a very daunting national debt. As a pinnacle for prosperity throughout the world a U.S. debt crisis threatens serious consequences that would ripple across the globe (see Chart 5).

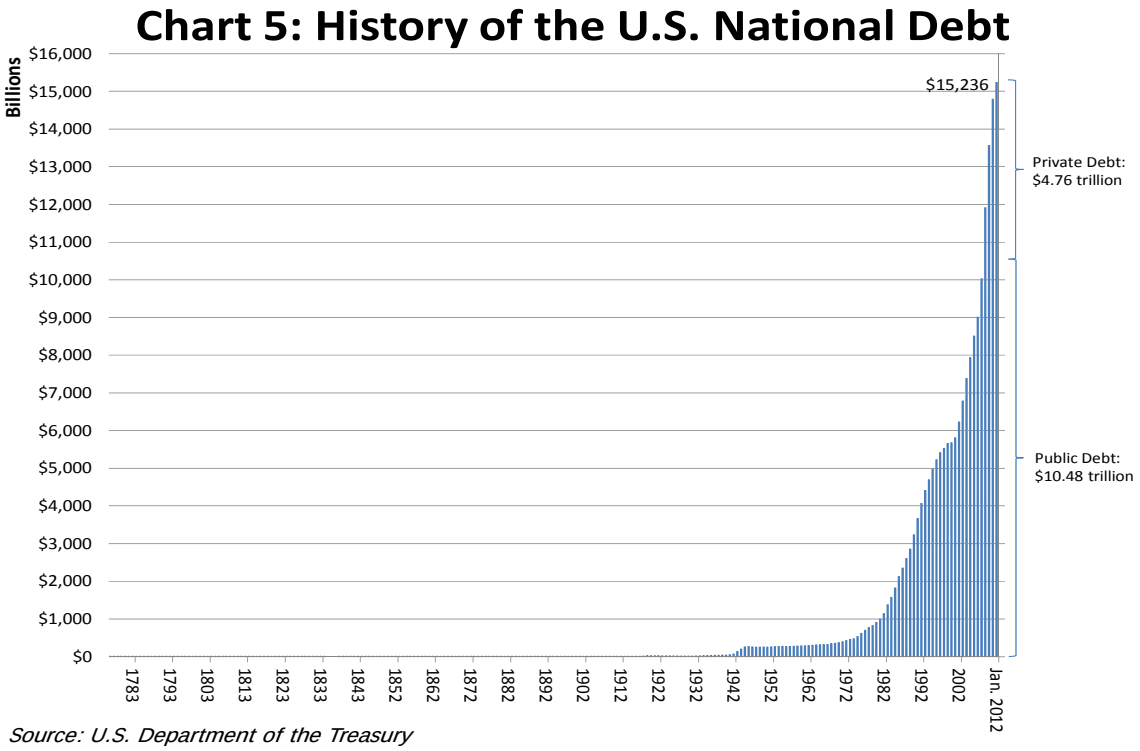


Chart 6 provides a very grim picture of the U.S.'s current debt crisis. As shown in the table, 91 percent of interest-bearing debt held by private investors, most likely in the form of treasury securities, will fall due within the next ten years. This looming liability places a very pressing and urgent demand on the U.S. government to raise large amounts of revenue in a relatively short period of time since government appears unwilling to cut spending. To do so the U.S. government has four options: increase taxes, use inflation, issue more debt, or a combination of the three. Regardless of the method chosen, the American public will be the ultimate loser and will either experience less disposable income, a lower purchasing power or a higher cost of financing, depending on which approach is used.

Another facet to this crisis is the interest payment. In 2010 the U.S. paid $413 billion in gross interest payments, which appears completely out of line when compared to the $143 billion spent on education in that same year. Over the next ten years interest payments are only expected to grow as the debt level continues its upward trend and interest rates rise. In 2010 the average interest rate paid on the debt was just 2.96 percent due to the Federal Reserve's effort to keep rates low in order to spur private borrowing and investment. However, interest rates are largely Procyclical. If the U.S. continues to recover from its most recent financial crisis, and inflation increases, it can be reasonably assumed that interest rates will increase as well, making financing the national debt that much more expensive (see Chart 6).

Chart 6: Financing The U.S. National Debt: 2010 Data	
Debt	
Debt Held by the Public As a Percentage of GDP	
Actual 2010	62.20%
Projected for 2015	67.10%
Projected for 2020	69.20%
Interest-Bearing Debt Held By Public Investors (As of June 2010)	
Falling Due Within 1 Year	33.25%
Falling Due Within 5 Years	71.53%
Falling Due Within 10 Years	90.76%
Holders of the Public Debt (At End of 2010 Fiscal Year)	
Domestic Investors	52.80%
Foreign Investors	47.20%
Interest	
Average Interest Rates (As of June 30, 2011)	
Marketable	2.38%
Non-marketable	4.07%
Total	2.96%
Gross Interest Payments on Treasury Debt Securities (in billions)	
Fiscal Year 2011 To Date	386
Actual 2010	413
Projected Net Interest Outlays (in billions)	
Actual 2010	197
From 2011-2015	1712
From 2011-2020	5079
Net Interest as a Percent of GDP	
Actual in 2010	1.40%
Projected for 2015	2.70%
Projected for 2020	3.40%

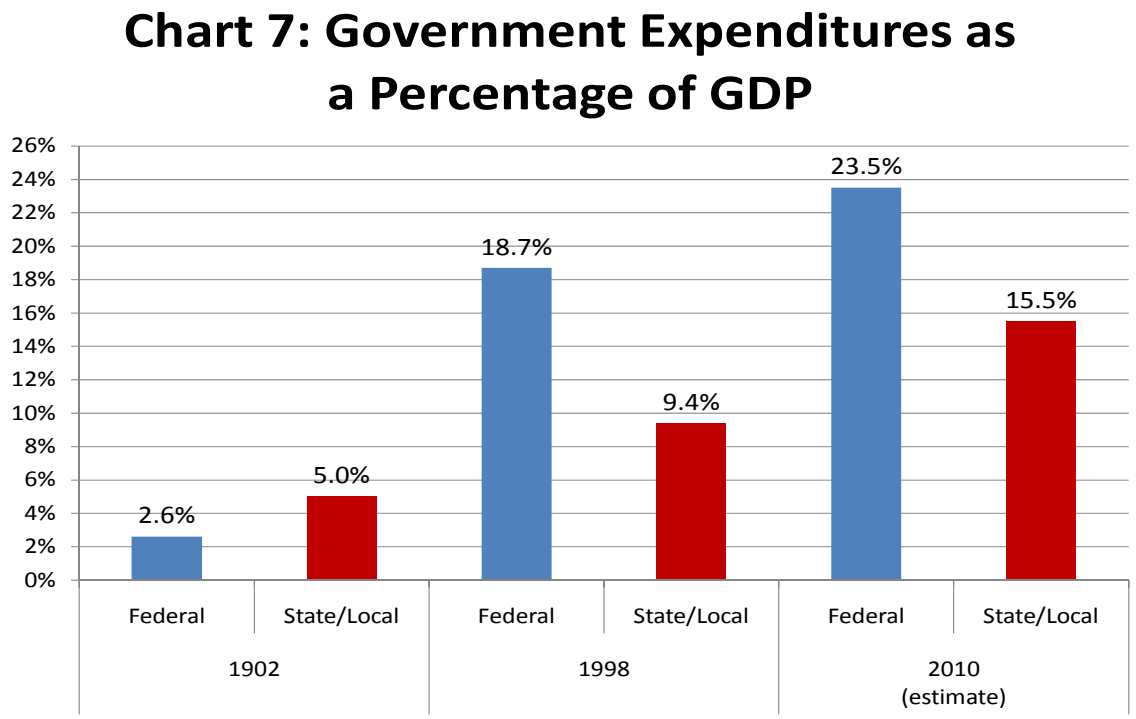
Sources: Congressional Budget Office and U.S. Department of the Treasury

Section II: Growth of Government

There is no doubt that government today is much larger than it was throughout the 20th century and one of the areas in which government has seen the largest growth is spending. The chart below (see Chart 7) illustrates this growth by plotting government spending as a percent of GDP, which is perhaps the best indicator of the overall health of the U.S. economy. During the 20th century and the first decade of the 21st century, America saw very healthy growth in GDP as it embraced the ideas of creative entrepreneurs and fostered invention and innovation with continual focus on increasing productivity and efficiency while meeting customer needs. However, the graph clearly shows that over this period government spending actually increased as a percentage of GDP meaning that growth in government spending outpaced the growth in GDP. This was true at every level of government. As seen in the graph, from 1902 to 1998 overall government spending grew from 7.6 percent of GDP in 1902 to 28.1 percent of GDP in 1998 and from 1998 it has grown to 39 percent of GDP. The trend which is especially troubling is the rapid growth in spending on the state/local level over the last 12 years, which has expanded by nearly 60 percent as a percent of GDP from 1998 to 2010. This increase in spending has left many state governments in a worse fiscal situation than what the federal government is facing with its current debt crisis.

As governments at every level go about tackling their debt problems, the discussion must not be limited to increasing revenues. Rather, revenue increases (a last resort) can only be considered after large spending cuts have been made if any true progress is going to be realized. Currently,

every state in the union, excluding Vermont, has a constitutional balanced budget amendment. Hopefully, these amendments will help state governments reel in spending and return them to a more fiscally responsible manner of operation (see Chart 7).



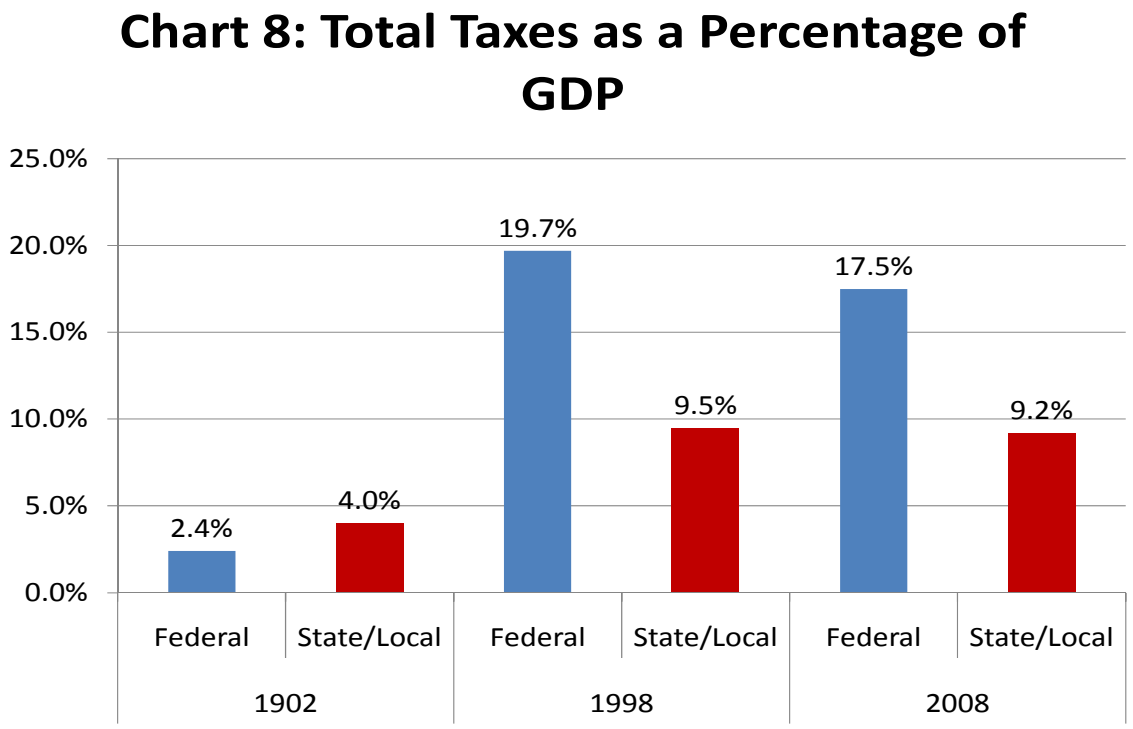
Sources: Joint Economic Committee Report 1999, 2011 U.S. Statistical Abstract and the Bureau of Economic Analysis

Looking at Chart 8, two separate trends can be identified. The first is an expansion of government throughout the 20th century followed by what appears to be a reduction in the first decade of the 21st century.

Clearly, from 1902 to 1998 tax revenues as a percentage of GDP increased at all levels of government, although this increase was most significant at the federal level. This can largely be explained by the move from consumption based taxes to production based taxes. The most prominent example of this change is the creation of a permanent income tax, which resulted from the adoption of the 16th amendment in 1913. From this amendment came the personal and corporate income tax which quickly became the federal government's foremost means of revenue.

From 1998 to 2008 there appears to be a reduction in the size of government as tax revenues as a percentage of GDP decreased at all levels of government due to tax cuts for some and a slowing economy. However, we believe this data may be misleading. Over this time period many countries in the OECD and around the world were cutting their corporate and personal income tax rates. During the same time the rates in the U.S. remained practically unchanged. This decreased tax competitiveness in the U.S. created an incentive for many American businesses to take their profits overseas where tax rates were much lower and they could avoid the arduous U.S. tax code. We believe this provides a needed explanation for why tax revenues as a

percentage of GDP decreased over the last decade rather than the claim of tax cuts and a slowing economy alone (see Chart 8).



Sources: Joint Economic Committee Report 1999, 2011 U.S. Statistical Abstract and the Bureau of Economic Analysis

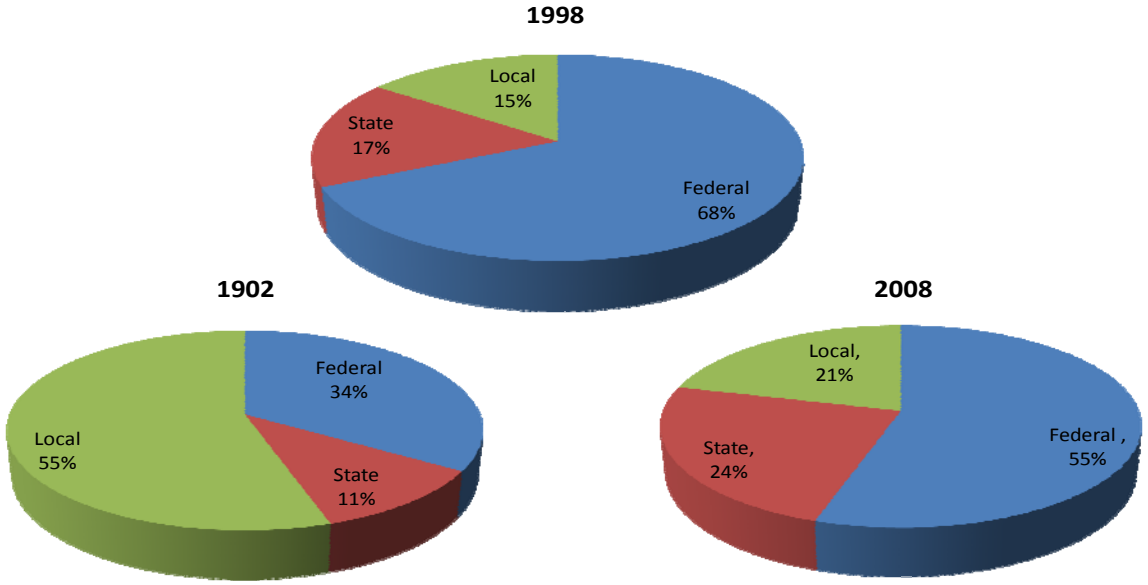
Fiscal Policy

Many economists and politicians are concerned about the future of the U.S. economy after disappointing economic results from more than two years and roughly $1.5 trillion in TARP and stimulus spending left unemployment hovering around 9.2 percent. Today, others are calling for additional stimulus dollars suggesting that increased government spending is truly the solution for the economy as recent policy underestimated "the severity of the problem" and the level of stimulus spending needed. It is easy to see that in more than 100 years the level of government expenditures as a percent of GDP has changed dramatically. It is also important to note that the focus of government spending at the local, state and federal level has changed dramatically over the same time frame (see Charts 9-11). However, it seems the presidencies of John F. Kennedy and Ronald W. Reagan serve as strong cases for the effectiveness of tax cuts in stimulating economic growth during difficult times. Recall what President Kennedy said about his own tax-cut based stimulus package in 1962: "In short, to increase demand and lift the economy, the federal government's most useful role is not to rush into a program of excessive increases in public expenditures, but to expand the incentives and opportunities for private expenditures." President Kennedy's tax cut was implemented after his death by President Johnson in 1964, with personal income tax rates declining 23.1 percent for the top income earners and 30 percent for the lowest. Corporate income tax rates were reduced by 9.6 percent the same year. The economy responded with an average annual real growth rate of 4.65 percent in U.S. GDP from 1963 to 1968, and unemployment dropped from 6.6 percent in 1961 to 3.7 percent in 1968.

President Reagan's across the board tax cut of 25 percent was phased in from 1981-1983 and helped bring the U.S. economy out of the severe economic recession of 1981-82 which saw the prime interest rate peak at 21.5 percent in 1981 (the highest since the Civil War), real GDP decline by 2.2 percent in 1982, and unemployment reach 10.8 percent also in 1982. The economy responded with an average annual real GDP growth rate of 3.87 percent from 1982 – 88, unemployment declined to 5.4 percent by 1988, and real tax revenue grew by 25.5 percent from 1983 to 1988. Recall that average government spending exceeded average tax revenue growth by 4.22 percent for most of the 1980's, thus creating the budget deficits of the Reagan years and hopefully providing evidence that tax cuts (today) can be powerful and government spending must be kept in check. Similar problems confront the U.S. and many European nations today. With government public debt and our national debt at record levels (see Charts 12 and 13) and government employment as a share of total U.S. employment rising from 4.1 percent in 1900 to 17.3 percent in 2010 (see Chart 14) it is imperative that we get government spending under control and figure out the most effective and efficient way to reduce the size and scope of government. Americans must understand that the dire consequences of not doing so are just around the corner…a preview of what the U.S. might face can be seen in the near bankruptcy of the Greek government, and the financial crisis in Ireland, Portugal and the whole of Europe (see Chart 15).

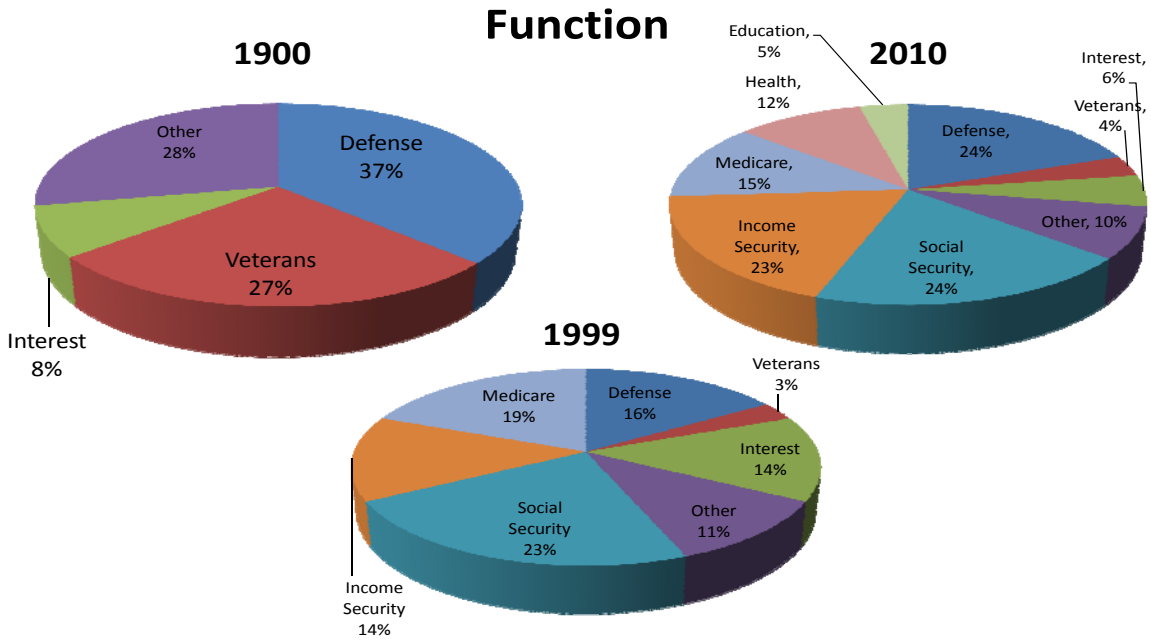
Finally, a study by President Obama's former Council of Economic Advisors, Chairperson Christina Romer and her fellow University of California, Berkeley economist husband, David Romer, (published in 2008) found the "multiplier effect" for tax cuts is much greater than the "multiplier effect" of government spending programs. In fact, it directly contradicts the 2009 Obama administration's research that the government spending multiplier was 1.57 while the tax cut multiplier was only .99. The Romer's research concluded that the "multiplier effect" of tax cuts is 3.0. In addition, a study by Valerie Romey (University of California, San Diego) finds the government spending multiplier to be only 1.4 while Andrew Mountford (University of London) and Harold Uhlig (University of Chicago) determined that tax cuts are four times more effective than increased government spending to jump-start a failing economy. The following is an example of the theory behind the "multiplier effect": If government cut taxes by $100 billion dollars and "the multiplier" was 2, the tax cut would lead to $200 billion in additional GDP. Due to economic uncertainty and the threat of tax increases, we believe companies will continue to cut costs (and labor) and strive for productivity increases while attempting to hold quality at high levels. Pressure to outsource will continue unless the cost of doing business in the U.S. improves. The need to cut wasteful government spending is at an all-time high and it should be coupled with a Kennedy-Reagan style (across the board) tax cut which will increase tax revenue to the government and ignite consumer and investor confidence. If we do not, there is a high likelihood of another downturn in 2011 or 2012.

Chart 9: Government Expenditure by Level



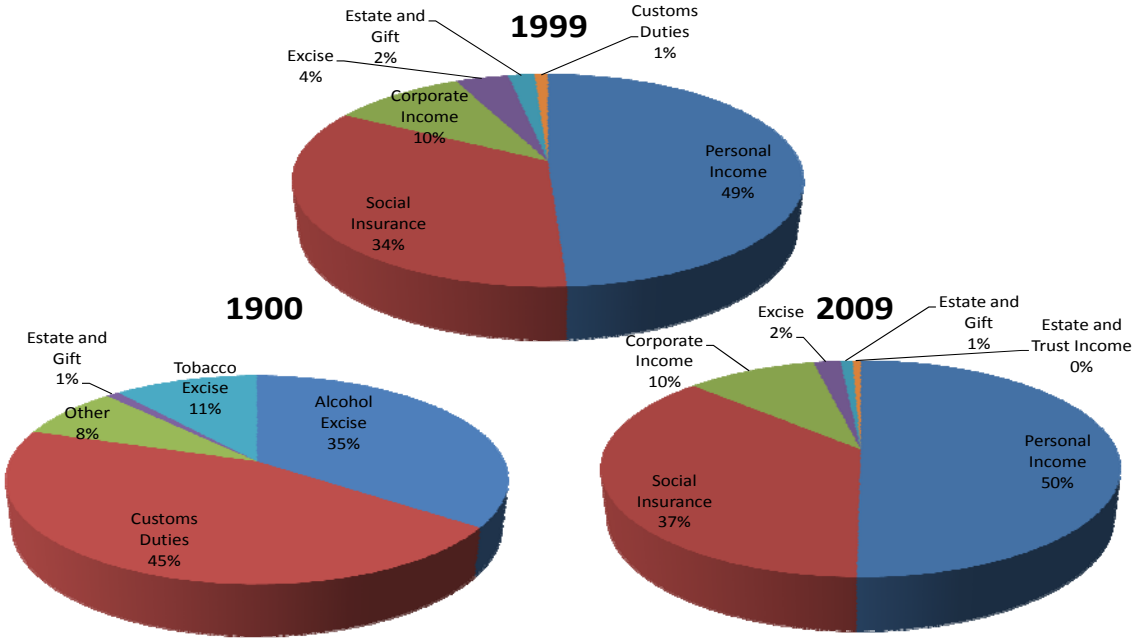
Sources: Joint Economic Committee Report 1999, 2011 U.S. Statistical Abstract

Chart 10: Federal Government Expenditure by Function



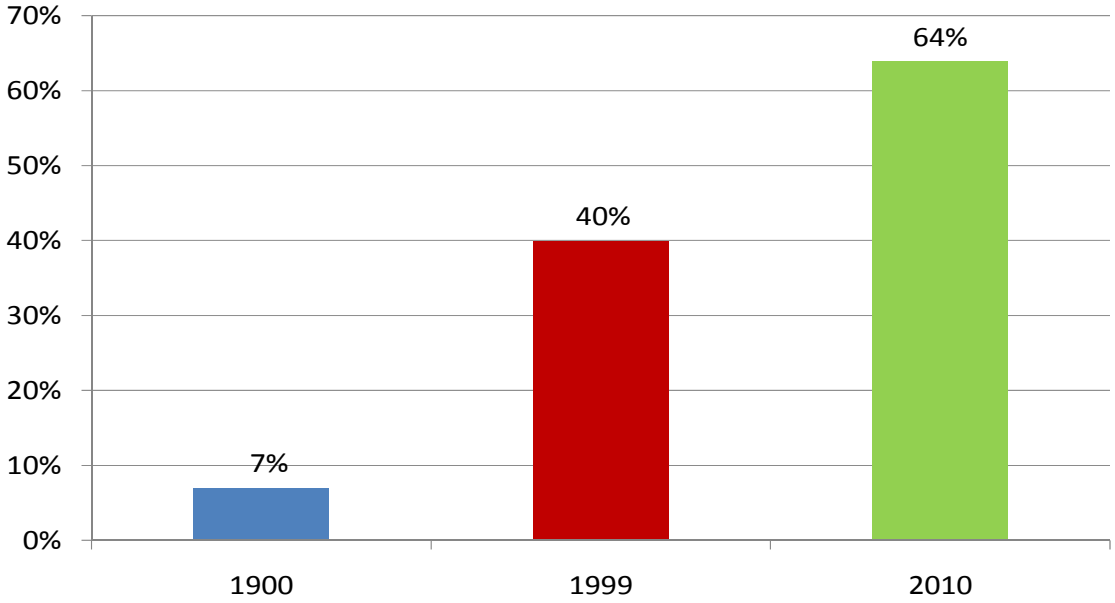
Sources: Joint Economic Committee Report 1999, 2011 U.S. Statistical Abstract

Chart 11: Federal Government Taxes by Type



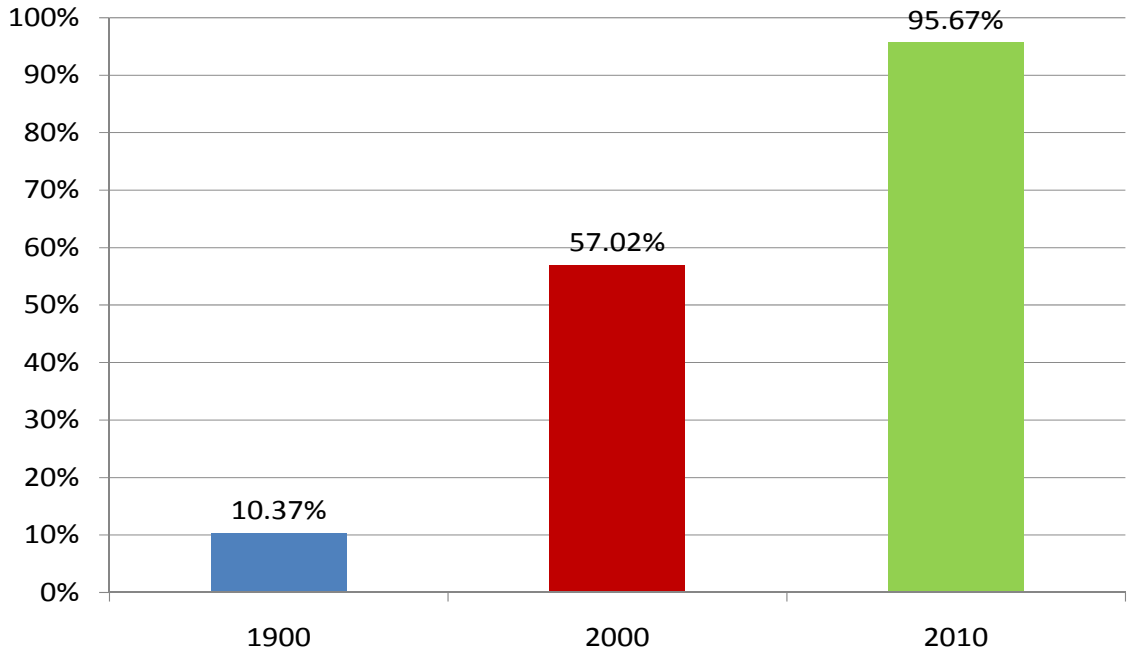
Sources: Joint Economic Committee Report 1999, 2011 U.S. Statistical Abstract

Chart 12: Federal Government Public Debt as a Share of GDP



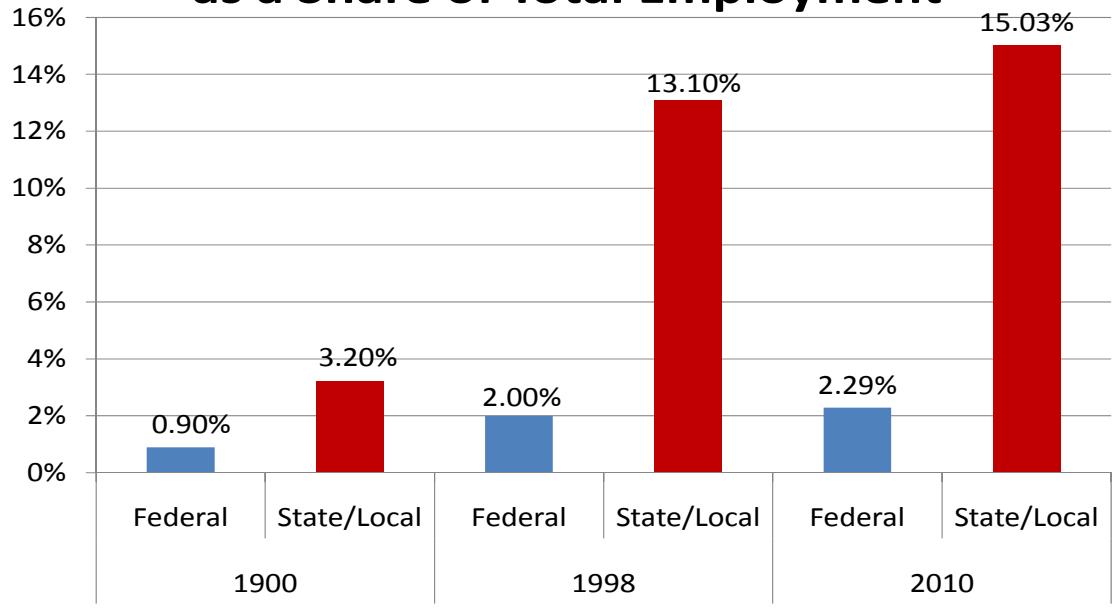
Sources: Joint Economic Committee Report 1999, U.S. Department of Treasury and the Bureau of Economic Analysis

Chart 13: National Debt as a Percentage of GDP



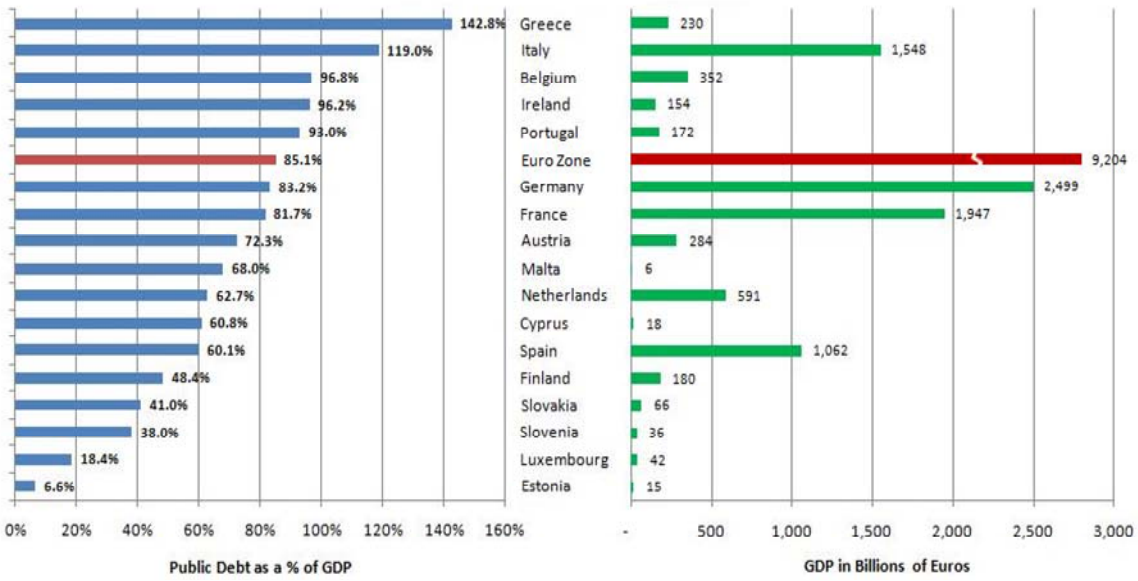
Sources: Joint Economic Committee Report 1999, U.S. Department of Treasury and the Bureau of Economic Analysis

Chart 14: Government Employment as a Share of Total Employment



Sources: Joint Economic Committee Report 1999 and the Bureau of Labor Statistics

Chart 15: Public Debt in the Euro Zone



Sources: Eurostat 2010, Yahoo News

Section III: Empirical Data and a Need for Change

U.S. Corporate and Personal Tax Rates

The American economy is changing and not for the better. Over the last 24 years, corporate tax rates in Organization for Economic Cooperation and Development (OECD) countries went from an average rate of 45 percent to less than 27 percent. The OECD represents thirty of the largest, freest and most productive economies in the world. Recently, with the increased mobility of multinational corporations, tax competition has intensified leaving businesses operating in the United States at a competitive disadvantage, with the second highest corporate tax burden in the world (39.27 percent), slightly lower than Japan (39.54 percent). From 2000 to 2010, 25 out of 30 OECD countries cut their corporate tax rate, 4 left it unchanged and Hungary increased its rate from 18 percent to 20 percent. The result is that the average rates in OECD countries dropped from 33.69 percent in 2000 to 26.60 percent today. The average OECD rate is nearly 13 percentage points below the U.S. tax burden on corporations, making it difficult for America to compete at a corporate tax rate almost 50 percent higher than the OECD average. Even more so, it is difficult to understand U.S. corporate tax rates given the lower corporate tax rates in former communist countries like Russia (24 percent), China (25 percent) and India (33 percent) (see chart 16).

In 1980, the top 5 percent of personal tax returns filed paid just over 40 percent of the total individual federal income taxes received by the government and paid an average tax rate of 26.85

percent. According to IRS data from 2008 (most recent available) the top 5 percent paid just under 60 percent of the individual federal income taxes received by the federal government and paid an average tax rate of 20.69 percent. Lower tax rates create incentives to work hard, earn more money, spend, save, invest and often pay more in net taxes as evidenced by the top 5 percent of income earners in 2008. Higher tax rates almost always create disincentives to work hard, produce more and pay taxes; proposed higher taxes on the top 5 percent of income earners is not what this nation needs. (see Charts 17-19).

Global Issues and Taxation

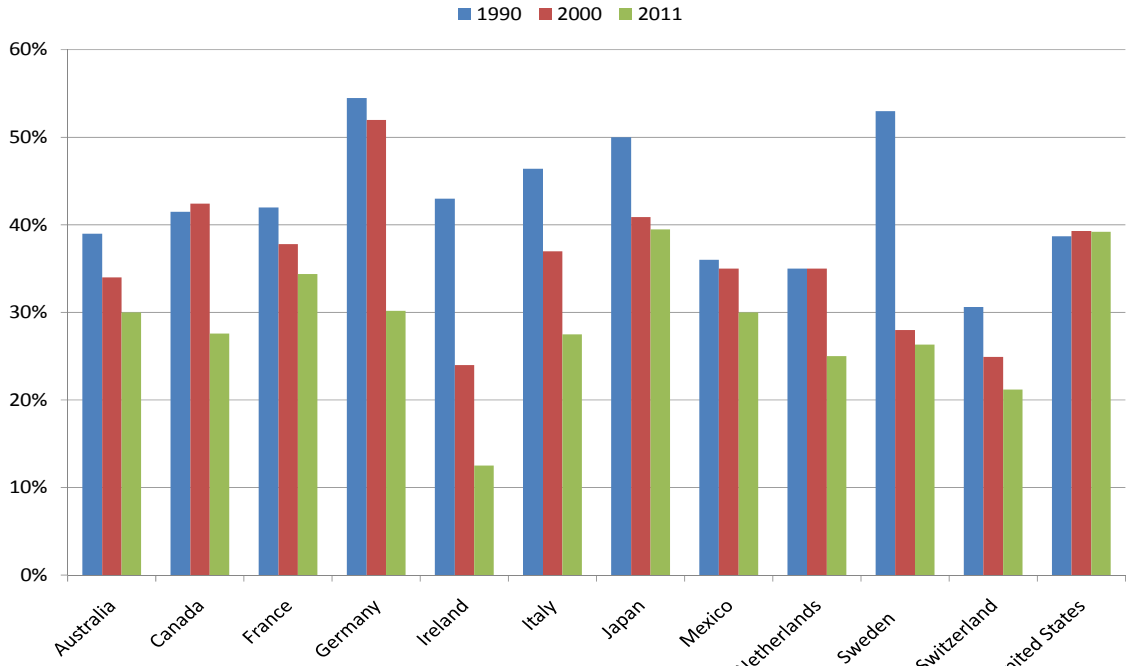
The U.S. corporate tax problem worsens globally when you consider a company's foreign operations. Assume General Motors (GM) and Toyota (Japan) operate plants in Ireland and each earns profits of $1,000,000 there. Under current tax law, Toyota pays the 12.5 percent Irish corporate income tax rate, but avoids the 39.54 percent Japanese corporate income tax rate because Japan operates under a territorial system. Therefore, they only pay $125,000 in taxes in Ireland (the territory of operation) and net $875,000 which they can repatriate back to Japan at no further cost in Japan.

On the other hand, GM pays the 12.5 percent Irish corporate income tax rate ($125,000). If they repatriate their income to the U.S., they must pay the U.S. tax rate of 39.27 percent (on average) on the $875,000 earnings after taxes. This comes to $343,612.50. At this point, they take their credit of $125,000 for foreign taxes already paid, bringing their U.S. taxes owed down to $218,612.50 ($343,612.50 - $125,000). GM will net $656,387.50 or pay an effective tax rate of 34.36 percent by repatriating profits back to the U.S. versus their Japanese competitor at 12.5 percent when repatriating Irish earned profits back to Japan.

Today over 80 percent of OECD nations have adopted a territorial tax system. The United States is just one of five OECD countries to operate with a worldwide system, and of these five nations the U.S. is the only country to have a corporate income tax rate over 30 percent. In fact, the U.S. combined average (state and federal) corporate income tax rate is the second highest in the OECD and the third highest in the developed world. With a combined corporate income tax rate of 39.27 percent the U.S. dwarfs the tax rates of some of our largest global competitors such as China (25 percent), India (33 percent), Russia (16 percent), and Germany (29.44 percent). This disparity between rates is largely due to a global tax reform trend centered around cutting corporate income tax rates. According to KPMG, an international tax and auditing firm, the global average tax rate on corporations fell from 32.69 percent in 1999 to 25.51 percent in 2009. All the while the U.S. rate has remained relatively untouched producing the incentive for companies to move production abroad in order to escape the higher U.S. tax rate.

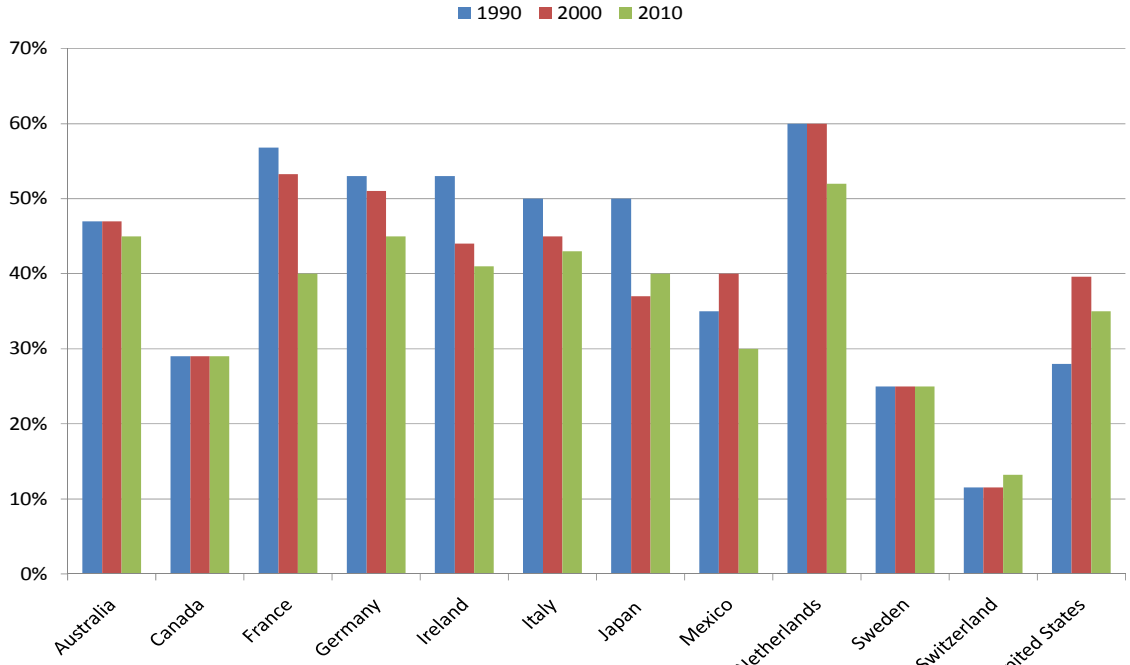
Tax rates are becoming increasingly important in investment decisions as capital becomes ever more mobile in the global market place. Whether the U.S. moves to a territorial system (home country tax does not apply) or keeps our current system, a cut in the corporate income tax rate must be included in any tax reform if we are to make real progress in enhancing U.S. global competitiveness.

Chart 16: Corporate Income Tax Rates in OECD Countries

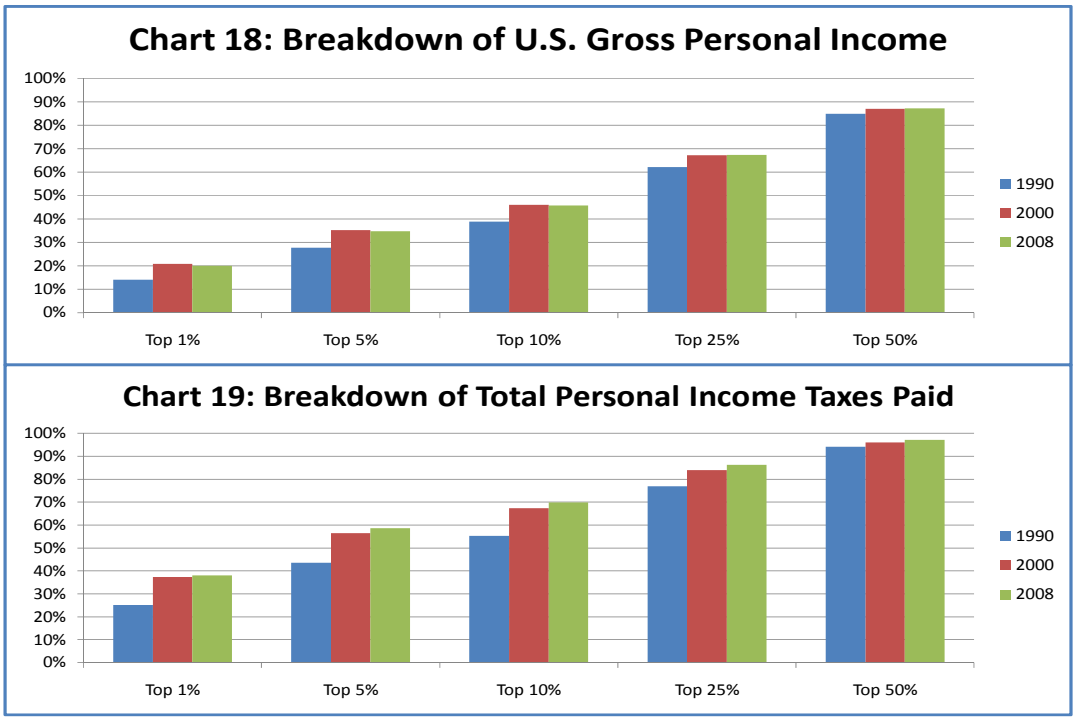


Source: The Organization for Economic Cooperation and Development

Chart 17: Personal Income Tax Rates in OECD Countries



Source: The Organization for Economic Cooperation and Development



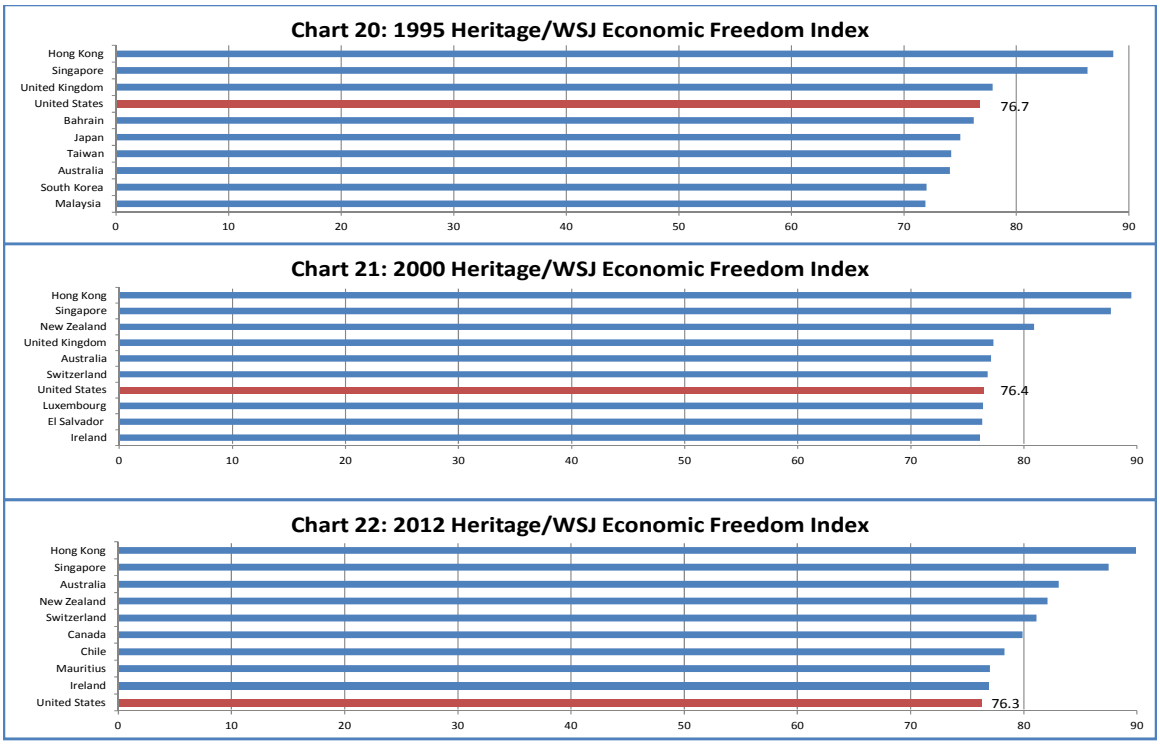
Source: IRS.gov

Regulation

Economic freedom is the right of every individual; that is the right to control one's own property and labor and use it in whatever manner seems best, provided that the liberty of others is not encroached upon when doing so. The Heritage Foundation and the *Wall Street Journal* describe an economically free society as follows: "In an economically free society, individuals are free to work, produce, consume, and invest in any way they please, with that freedom both protected by the state and unconstrained by the state. In economically free societies, governments allow labor, capital and goods to move freely, and refrain from coercion or constraint of liberty beyond the extent necessary to protect and maintain liberty itself."

As an essential for achieving prosperity and a higher standard of living, tracking economic freedom is of the utmost interest and value. The Heritage Foundation and the *Wall Street Journal* have achieved this through their Index of Economic Freedom which calculates a numeric value for economic freedom where a higher value equals a more free society. To calculate this number the following ten components are considered: business freedom, trade freedom, fiscal freedom, government spending, monetary freedom, investment freedom, financial freedom, property rights, freedom from corruption and labor freedom.

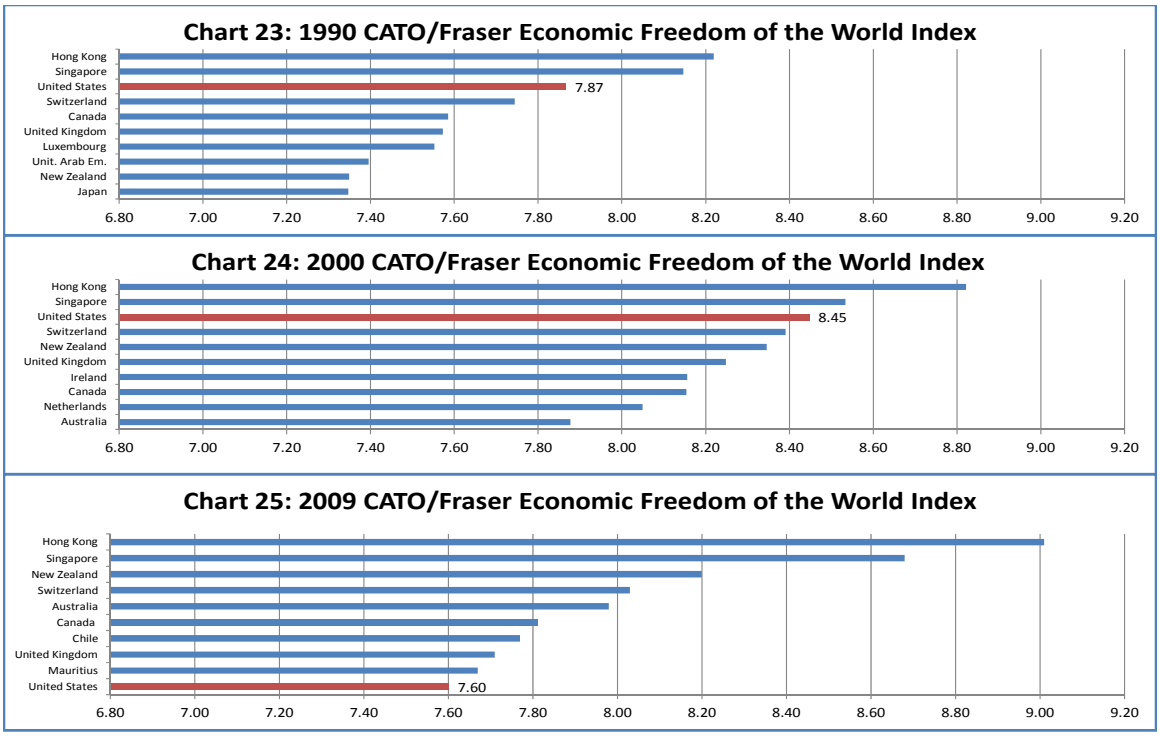
The U.S. has long been heralded as the "land of the free" and in 1995 was ranked fourth in the world in economic freedom. Since then, however, the U.S. has steadily fallen in the rankings and in the most recent 2012 index the U.S. settled in the tenth position (see Charts 20-22).



Sources: The Heritage Foundation and the Wall Street Journal

Very similar to the Heritage/WSJ Economic Freedom Index, the CATO/Fraser Economic Freedom of the World Index aims to calculate a numeric value for economic freedom with the intention of shedding light on the connection between economic freedom and prosperity. With the belief that the cornerstones of economic freedom are personal choice, voluntary exchange, freedom to compete and security of privately owned property, this index calculates economic freedom by assessing the following areas of each country: size of government – expenditures, taxes and enterprises; legal structure and security of property rights; access to sound money; freedom to trade internationally; and regulations of credit, labor and business.

This index confirms the conclusion drawn from the Heritage/WSJ index: from a comparative standpoint the U.S. has become less economically free over the last two decades. According to the CATO/Fraser Economic Freedom of the World Index, the U.S. ranked third in the world in 1990 and 2000. However, in the most recent index, the U.S. fell to tenth in the world while economies like Hong King and Singapore continue to lead the way in promoting economic freedom and more robust economic growth. (see Charts 23-25).



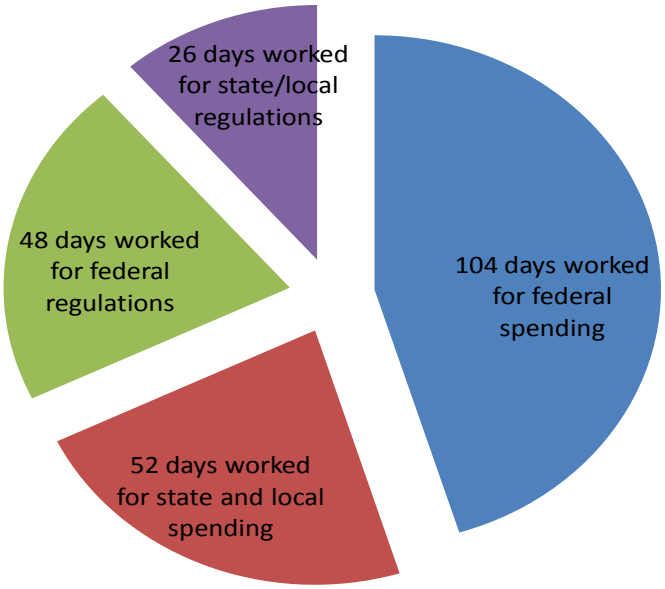
Sources: The CATO Institute and Fraser Institute

Who We Work for is Becoming an Issue of Great Concern

According to the Washington, D.C. based Tax Foundation, in 2010 the average American worked 102 days, or until April 12th to pay their share of local, state and federal taxes. In 2010, based on data from the U.S. Congressional Budget Office (CBO), the average American worked 156 days, or until June 9th, to pay their share of local, state and federal government spending. Finally, the Center for Fiscal Accountability concluded that the average American worked 230 days, or until August 19, 2010 to pay for the total cost of government, which includes higher prices on goods, services and assets due to local, state and federal regulatory costs, as well as government spending at all levels.

Perhaps it is the realization that we work eight extra days in 2010 vs. 2009 because government could not keep spending in line with tax revenue that has caused much of the concern in our current economy. Or could it be that we worked 74 days in 2010 to cover the cost of regulation at all levels? Could the cause of much of the discontent be the fact that average Americans will work roughly 7 ½ months paying for government at all levels and only 4 ½ months for themselves in 2010? Or maybe, just maybe, it is the realization that by 2020 we could be working into September or October to cover the cost of government if real reform is not realized soon. No rational person would argue that we do not need government; however, many rational people are asking how *much* government do we need? Perhaps 1902 levels were more reasonable (see chart 26)?

Chart 26: Who Do We Work For?



Source: Center for Fiscal Accountability, 2010

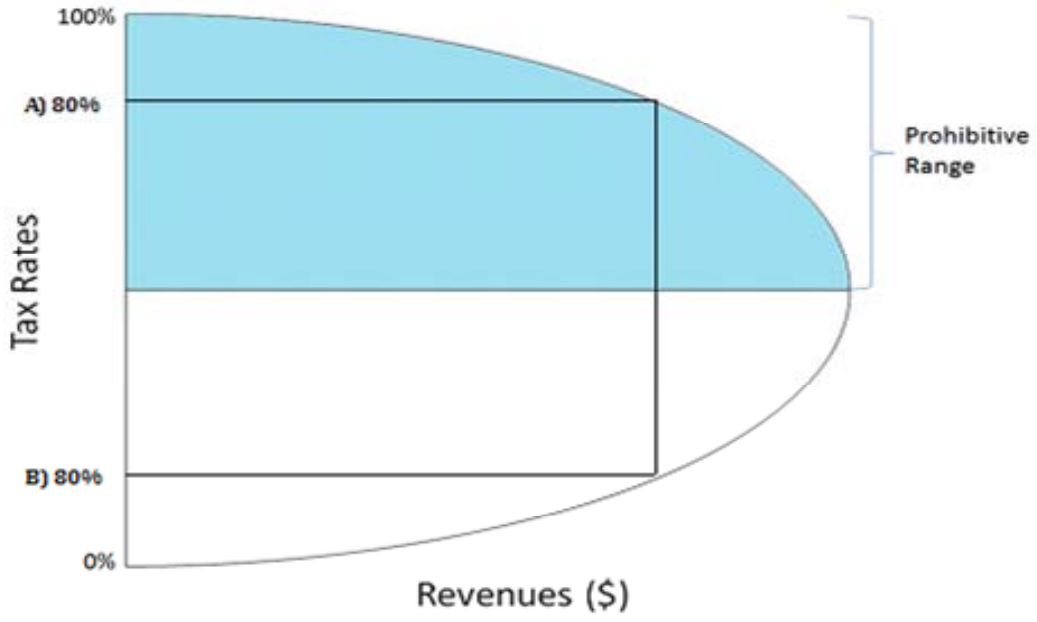
Rational Tax Policy

Named after Arthur Laffer, a well-known economist who served in the Kennedy and Reagan administrations. The curve is meant to depict the relationship between the marginal tax rate and the resulting level of government revenue.

The basic economic premise is that individuals respond to incentives, and are more willing to work, save and invest, given a greater return from an amount of productive effort undertaken. Thus, increases in the marginal tax rate – the additional amount extracted by government in taxes from any additional dollar earned – will at some point act as an increasing disincentive, resulting not only in less willingness to work, save and invest, but less government revenue as well.

The curve suggests that there are two marginal tax rates – a lower one and a higher one – each of which would generate the same amount of government revenue. The advocate of individual freedom and positive market incentives would argue that the lowest marginal tax rate consistent with the level of government revenue desired should be chosen, since the higher rate would unnecessarily reduce market incentives upon which future economic growth is dependent (see Chart 27). Our current progressive tax system is riddled with disincentives and excessively high marginal rates.

Chart 27: The Laffer Curve



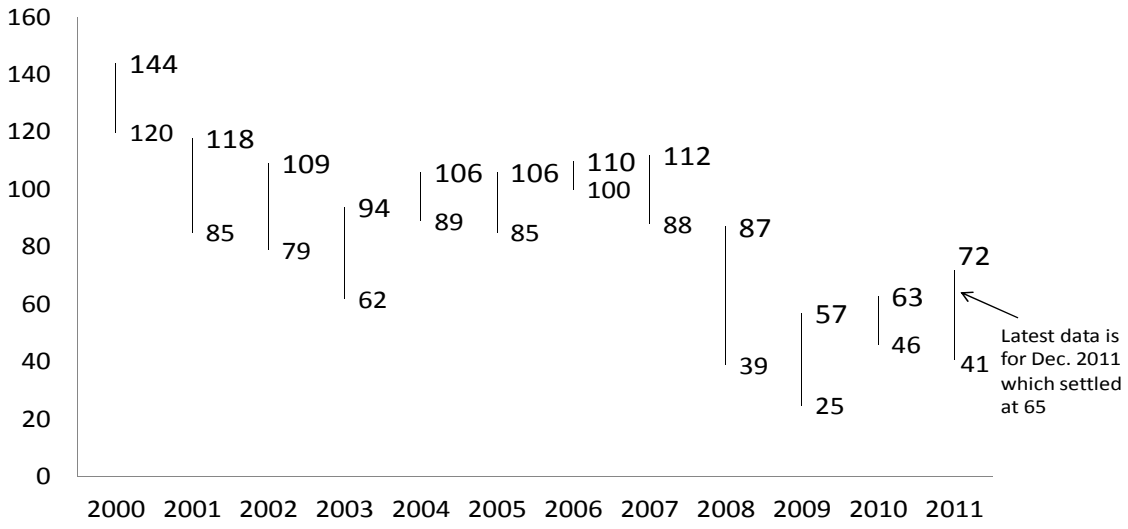
Source: Economics of Private and Public Choice

Americans Are Losing Confidence

U.S. Consumer Confidence, reported on a monthly basis by The Conference Board, measures consumer perception of the state of the U.S. job market, economic outlook and business conditions as a whole for the next six months. The graph (see Chart 28) shows the high and low for each year.
On the heels of the tech boom at the turn of the 21st century consumer confidence was at an all time high reaching 144. When the dot-com bubble burst and the market crashed, many investors caught up in the frenzy of the internet boom were left with investment portfolios a fraction of their former size. Couple this with the September 11th terrorist attacks on the World Trade Center and the Pentagon, and U.S. consumers had much to feed their pessimism. This is seen on the graph as a steady decline from 2000 to 2003, bottoming out at 62, nearly 60 percent lower than the high in 2000.

In 2003, Consumer Confidence began to work its way back until the most recent recession hit, causing the index to plummet to its lowest level since its inception in 1967. At a lowly level of 25, consumer confidence was at a mere 17 percent of its high of 144 in 2000. Following this low, consumers began to regain confidence in the economic prospects for the U.S. over the next year and a half as the economy climbed out of a hole. However, worries over the ongoing regulatory burden, the debt crisis, healthcare reform and its costs, and the threat of tax increases caused it to slump again, dropping the index as low as 41. But 2011 finished on a high note climbing from its low of 41 to 65 in just two months. (see Chart 28).

Chart 28: Consumer Confidence



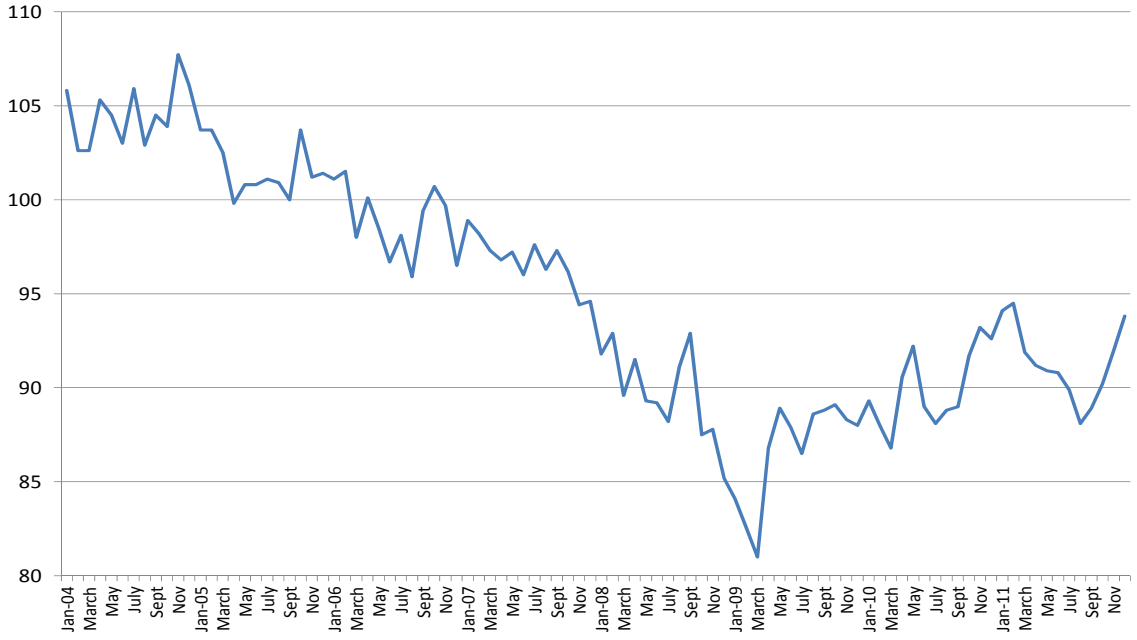
Source: The Conference Board

Very similar to the Consumer Confidence Index, the Small-Business Optimism Index produced monthly by the National Federation of Independent Business (NFIB) illustrates the overall sentiment of small business owners regarding the future of the U.S. economy. The index is seasonally adjusted and scaled so that the 1986 index level equals 100. The index is comprised of ten components including expected credit conditions, earnings trend, current job openings, and plans to make capital outlays among others.

With the role small businesses play in a healthy economy creating the majority of jobs and fostering economic growth, the conclusions drawn from this index are of a particular importance. Looking at the graph it can be seen that the fluctuations generally mimic those of the consumer confidence index. One point of interest, however, is that the Small Business Optimism Index appears to have turned negative prior to consumer confidence. Starting in late 2005/early 2006, small business owners felt less and less positive about future economic trends. On the other hand, consumer confidence didn't really dip until 2008. Because business owners are more in tune to their surrounding economic climate, one might conclude that while consumer confidence is more retrospective in its movements, the small business confidence index is more prospective.

Very similar to consumer confidence, however, the small business index reached the bottom of its trough in 2009 and had been trending toward recovery until the beginning of 2011. The index fell quickly through the first half of 2011 during which the index saw much more pessimism than optimism on behalf of small business owners. However, the index finished strong by increasing for four consecutive months to end the year (see Chart 29).

Chart 29: Small Business Confidence Index

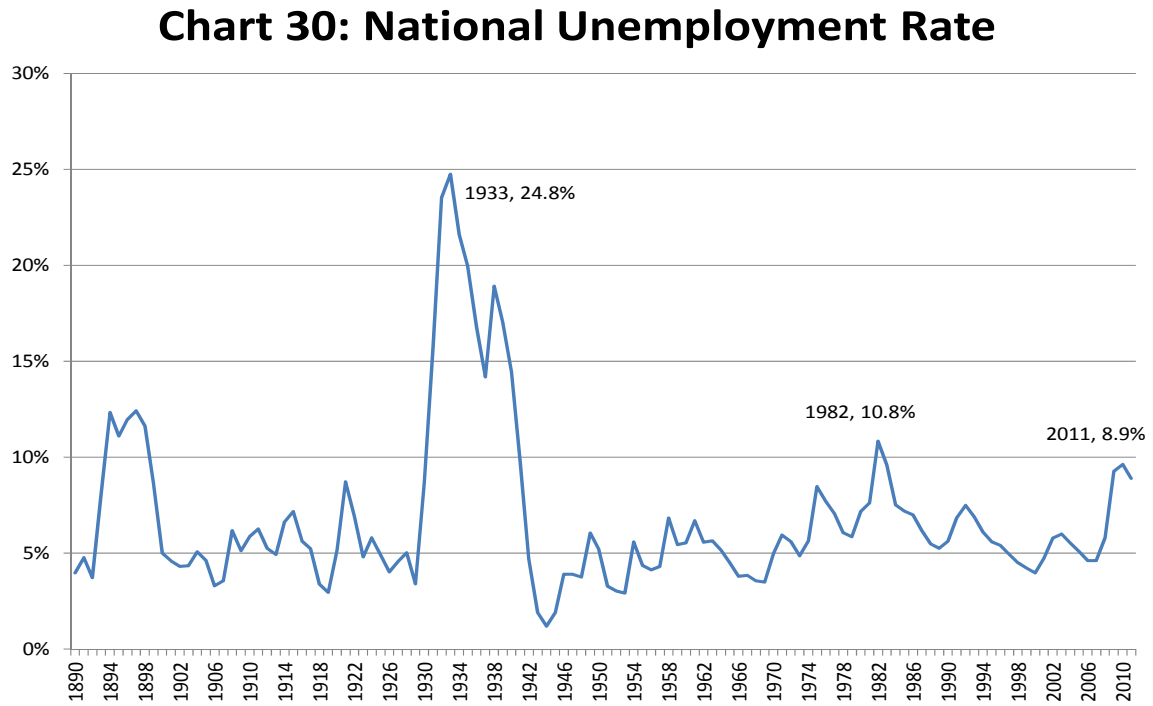


Source: National Federation of Independent Business

As one of the most widely used indicators of economic well being, the national unemployment rate is closely monitored by politicians and economists alike. During tough financial times such as the economy the U.S. is currently in, the unemployment rate becomes of even greater importance as many citizens seek help from politicians who will likewise try to generate the creation of jobs through different federal spending programs.

Truth be told, however, the unemployment rate, as seen in the graph (see Chart 30), is largely procyclical and no amount of government spending can offset that...recent policy shows that it can in fact exacerbate it. This is best seen during the Great Depression in the years following the stock market crash of 1929 when unemployment reached 24.75 percent. This level of unemployment decimated the U.S. and took it through one of its darkest times in its history. It wasn't until World War II that the unemployment rate receded to a reasonable level. Over the last 60 years the unemployment rate has primarily hovered between three and six percent, pointing to a natural rate of unemployment somewhere within that range (5.5 percent) when rational and predictable government policy is in place. Only on two occasions, the recession of the early 1980's and the most recent recession that followed the bursting of the housing bubble, has unemployment significantly exceeded this range (see Chart 30).

Many economists would argue that unemployment figures lack accuracy because of their failure to account for underemployed and discouraged workers who have given up on their job search. The U-6 unemployment rate, which is a broader measure of unemployment which accounts for the aforementioned workers, shows that the real unemployment rate may have reached as high as 17.4 percent in October 2009 and still sits at 15.2 percent in December 2011, according to the latest data.



Source: The Bureau of Labor Statistics

Conclusion

More than 234 years ago, on December 23, 1776, American statesman Thomas Paine's *American Crisis Volume I* was published. The work opens with his now famous words, "These are the times that try men's souls. The summer soldier and the sunshine patriot will, in this crisis, shrink from the service of their country, but he who stands now, deserves the love and thanks of man and woman." Also during this time, Paine authored a series of pamphlets entitled, *Common Sense*, through which the American colonists and the Continental Army could in clear and thoughtful terms understand the issues and difficulties facing a new nation just into revolution. Our current economic problems are not yet "trying our souls" but certainly this is a time that calls for "common sense" and for clear and thoughtful reasoning, statesmanship and long-term solutions to the challenges we face. It is time for bi-partisan action, for solutions that emanate from the White House and Congress and relate to both Wall Street and Main Street. It is perhaps more imperative than ever before that Washington focuses on sound and rational bi-partisan economic and political policy solutions rather than political solutions if America is to remain the world's beacon of freedom, hope and prosperity. Today, the need for statesmanship is at a premium rarely seen in the history of this country.

One only needs to watch the Sunday news shows on television or read a wide range of internet, newspaper or magazine articles to find that there is no "common sense" consensus on the causes of the problems facing America; many explanations seem to point to the failure of capitalism; even more disturbing pronouncements claim that capitalism has simply run its course in economic history. It is important to state again that supporters of capitalism have never claimed

capitalism was a perfect economic system. It is, however, the best that humankind has been able to devise to date. Nobel Laureate economist Friedrich von Hayek saw the truth of this when he observed, “I very seriously believe that capitalism is not only a better form of organizing human activity than any deliberate design, any attempt to organize it to satisfy particular preferences, to aim at what people regard as beautiful or pleasant order, but it is also the indispensable condition for just keeping that population alive which exists already in the world. I regard the preservation of what is known as the capitalist system, of the system of free markets and the private ownership of the means of production, as an essential condition of the very survival of mankind.”

This great country and free economies throughout the world are the product, if you will, of the capitalist system. Molded largely by the actions of free people, entrepreneurs – calculated risk-takers who see opportunities that few can, and have the courage and wisdom to create a business and bring these opportunities to fruition -- and intrapreneurs (individuals with the courage, wisdom, and vision to bring about entrepreneurial change within an established business) who took risks and forged new ideas, systems and products to better themselves, customers and their communities. It is unfortunate, after more than two centuries of practice and results, that entrepreneurs and intrapreneurs are still misunderstood, rare and vital leaders who are often over-criticized for their actions and then under-rewarded for their successes. The bold actions of entrepreneurs and intrapreneurs have structurally changed our economy time and again, bringing dramatic improvement to life expectancies and our standard of living and provide rates of return for common investors to buy homes, send their children to college, retire and much more. For example, roughly 90 percent of Americans earned their primary income from farming in 1776. As a result of centuries of open competition in agro science and farm technology, roughly 1 percent of today's population feeds the entire nation and exports food across the globe, while the rest of us produce automobiles, computers, and millions of other goods and services. Truly, the collective vision of countless entrepreneurs and intrapreneurs has created millions of businesses, jobs, and a tax base which allowed for our high standards of living and truly made this world a better place. We must defend this truth or Schumpeter’s prediction will come to fruition…many believe we are far down that path today.

American political and economic history rarely resembled a smooth road or a straight and unbroken trajectory to success. In fact, most businesses, organizations and political parties have had to endure turbulent times more often than they would like to admit - times that tried their very foundations, tested their organizational mettle, vision, and strategy, bringing out the best and worst in their leadership and challenging their moral fiber. During those times, leaders of free societies have righted wrongs, taken corrective actions with whoever or whatever needed to be changed, relentlessly recalibrating the compass of human progress back to its “true north.” We need such leadership today.

During these times one can benefit from revisiting the best-selling book, *Managing in Turbulent Times*, by Peter Drucker. Its lessons are certain to be helpful in bringing clarity to past and current issues of national and global concern. Drucker was prophetic when he predicted that an integrated world economy would offer great opportunities for managers who could see the need for change and lead their organizations through the turbulent times such an economy would surely present. Drucker noted that leaders in turbulent times would need to ensure that their

organizations have: a) the capacity to survive, b) structural strength and soundness, c) the ability to survive a "blow" and adapt to sudden change, and d) the ability to capitalize on new opportunities.

We are concerned over the shortage of common sense in Washington during these turbulent times. We believe this country lacks a fundamental understanding of what made America great. Many Americans are instead making our capitalist system the scapegoat for problems with roots in Washington. We believe it is an excellent time for our current administration and Congress to lead us through these turbulent times and restore to greatness these United States. We must not abandon our capitalistic roots for government ownership and control of the market economy. It has failed in the past and is being rejected with great success in countries from Hungary to India to China.

Beyond the above, government must address the following issues that stifle our ability to compete in today's complex global economy and hinder the functioning of the market. If they are not resolved, America will cease to be the wellspring of human progress now and in the future.

A Call for Bold Action

We ask our president and congress to carefully consider and debate the proper role and size of government in light of the concerns voiced in this paper and the strain on today's economy. We also hope the following suggestions will resonate as possible solutions.

1. Create a bi-partisan commission to investigate the reform of our federal corporate and individual tax systems and report back to the American people in one year. Strong consideration of a "fair tax," "flat tax" or a narrow tax range based on the research of growth-friendly economists like Arthur Laffer should be made. Countries such as Switzerland and Hungary seem to have had great success recently with low rate, more incentive-based tax systems. Tax reform must encourage job creation, savings and investment and not drive business overseas. We believe consideration of the "fair tax proposal" or a flat corporate income tax rate of no more than 20 percent, eliminating most exemptions and deductions, is a good place to start.

2. Create a bi-partisan commission to investigate a federal "Balanced Budget Amendment." As of 2002, forty nine states (excluding Vermont) have balanced budget requirements, most of which are written into their constitutions. Over the years, the total combined expenditure made by all fifty states annually is just under 50 percent of federal spending annually. Yet, the cumulative total of state debt realized over the same period is roughly one-tenth of the U.S. national debt indicating that mandated budget constraints seem to work. This task will not be easy considering that almost 60 percent of federal government spending today is mandatory in comparison to 27 percent in the mid-60s.

3. Create a bi-partisan commission that would study the opportunity to reduce the size, scope and cost of government by considering the privatization of programs such as social security, VA Hospital Administration, maintaining and building roads and even space exploration. Many countries such as Germany, Chile, Mexico and Japan are experimenting with privatization with

great success. Data contained in this report also indicates regulatory reform is needed to enhance American competitiveness around the world.

4. The United States needs to adopt a rational, market-driven monetary policy, not one beholden to the whims of the political process and the devastation of inflation.

5. More than 29 percent of all land in the United States is owned by the federal government. If a constitutional constraint on government spending were adopted it should force an end to the out of control government spending of the last thirty years. Then the federal government could consider the sale of some land and mineral rights to raise dollars to retire a significant portion of our national debt once and for all.

What Really Caused The Great Depression and The Great Recession?

As we are noting for the third time, capitalism is not a perfect economic system. It is simply the most efficient, productive, and caring system. Certainly business mistakes contributed to The Great Depression of the 1930's. However, it is clear that improper government monetary policy (a 25 percent contraction of the money supply from 1924 – 1929), a doubling of the U.S. income tax in 1932, U.S. trade policy via the Smoot-Hawley Tariff of 1930, the Wagner Act of 1937 and many other government interventions were the major culprits responsible for the depth and the breadth of The Great Depression…not an innate structural failure of capitalism.

The role of government in the cause or causes of our recent "Great Recession" is also under-reported. Economists, journalists and politicians must carefully examine the role of the Clinton and Bush Administration regulatory policies/authorities at all levels throughout our financial system from 1992 - 2008. Were they negligent in their responsibilities? If so, why? Did monetary authorities, largely Mr. Greenspan, overshoot interest rate targets, allowing for excessively low interest rates in the recent past, triggering the malinvestment beginning in 2004 that is still with us today? We must investigate charges that the noble intentions of the Community Reinvestment Act led to a reckless surge in mortgage lending pushing much of our financial system to the brink of chaos. We must investigate the role of Fannie Mae and Freddie Mac in the explosion of the subprime housing market. What was the role of government in funding these loans that ordinarily would not have been made based on long-held underwriting standards that historically call for: a) a down payment of 20 percent, b) a ratio of purchasing price to income not exceeding 2.5, and c) a payment history indicating credit worthiness (a minimum 650 credit score)? Was this proper public policy? How could subprime lending grow 2,757 percent from $34 billion in 1994 to a total of nearly $1 trillion by 2007 without any major intervention over 14 years and two administrations? What happened to proposed 2005 Senate legislation designed to reform Fannie Mae and Freddie Mac due to concerns voiced six years ago? Why has more than $1.5 trillion in TARP and stimulus spending not moved unemployment lower as promised in 2009? Is the government mandated "mark to market" method of valuing assets good and proper or was it a contributing factor to the financial crisis? Is "mark to economic value" a more logical methodology? Finally, is the current uncertainty over regulatory policy, tax policy, debt policy, medical reform, and the role of business in our free enterprise system causing much of the economic stagnation we are experiencing today?

When constructing this paper our intentions were two-fold. We first wanted to outline that the roots of the American dream run deep and strong in the soil of free enterprise capitalism. The United States enjoys the greatest standard of living for the largest population in the history of the world. America is still the beacon of liberty for people around the globe in part because of her productive and dynamic economy. We also wrote this paper to point out that America is much less free in 2011 than she was in 1900, a result of increased government spending and tax policy, government regulatory policy and unsound monetary policy. It is our hope that the data and suggestions outlined in this paper will contribute to the current debate in Washington D.C. over the role of government in the economy and the debt crisis. Perhaps government consumption of roughly seven percent of GDP in 1900 is too low for today's complex and dynamic U.S. economy, but we hope that this paper convinces its readers that the current size and scope of government (nearly 40 percent of GDP) is excessively high and our irresponsible deficit spending must be reversed immediately. If we do not address our current deficit problems now the U.S. will never be able to handle the projected cumulative deficits of $70 trillion America can expect to have accumulated by 2060 from underfunded government programs ranging from Medicare and Medicaid to Social Security, defense and interest on the national debt.

America has always risen to the occasion and met her challenges with principled solutions and a belief that her greatness and longevity were predestined. We believe in America and hope that our leaders in Washington will hear our call and address the concerns contained in this paper NOW for our future and that of our posterity.

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