The Heritage Foundation Backgrounder

No. 862 | The Heritage Foundation 214 Massachusetts Avenue N.E. Washington, D.C. 20002-4999 (202) 546-4400

October 23, 1991

A FIVE-PLANK PROGRAM FOR TRADE AND INVESTMENT WITH EASTERN EUROPE AND THE FORMER SOVIET REPUBLICS

INTRODUCTION

After a slow start, the new democratic governments in Eastern Europe are taking decisive steps to dismantle command economies inherited from their Stalinist predecessors and to build genuine free market systems. Yet a number of external economic shocks, including the temporary spurt in oil prices generated by the Persian Gulf war, and the collapse of trade with a dying Soviet Union, now threaten these fledgling economies. Needed desperately in coming months and years are increased trade with and investment from the West.

Severe Problems. East Europeans are faced with severe economic problems. Energy price increases due to the Gulf war alone cost Hungary $2 billion and Czechoslovakia $1.5 billion in hard currency. Although oil prices have returned to near pre-Gulf war levels, the massive below-market-price imports of oil from the Soviet Union have made East European countries far more energy dependent than the West. Moreover, Soviet oil deliveries to Eastern Europe have plummeted since 1990, sending East Europeans scrambling to set up barter deals for oil with individual Soviet republics. Soon they will have to pay for this oil, too, in hard currency, eating up most of the hard currency earnings that otherwise could be put to use by private investors to help build their economies.

East Europeans also are suffering from the rapid economic deterioration of the Soviet Union, Eastern Europe's largest trading partner, and a drastic drop in intra-East European trade. East European exports to the Soviet Union fell 48 percent in the first half of this year, while imports from the Soviet Union dropped 41 per-

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

cent. The drop in East European and Soviet trade cost Czechoslovakia alone over $2.5 billion by April 1991. Unless new markets quickly are discovered for East European goods, thousands of state and nascent private industries will go bankrupt.

In an attempt to assist the new democracies of Eastern Europe during this time of economic trial, the United States Congress now is hammering out the final version of a foreign aid package for the region. While well-intentioned, the legislation will do little to encourage economic growth and ease the precarious foreign trade situation in Eastern Europe.

Failed Policies. The bill relies mostly on those standard foreign aid policies that in the past quarter-century have failed dismally elsewhere in the world. These include ineffectual technical assistance offered mostly by the U.S. Agency for International Development (AID), and government loans and grants, which actually can delay economic development by removing incentives for wide-ranging economic reform.

The West Europeans are counting on a new multinational bank, the European Bank for Reconstruction and Development (EBRD), to be their main instrument for promoting economic development in Eastern Europe and the Soviet republics. There is little reason, however, to believe that this development bank will be any more successful in fostering economic growth than the other West European efforts or the World Bank have been in Africa.

East Europeans need and deserve more than traditional foreign aid. Ultimately, they need expanding trade with the West, which will create markets for their goods and increased Western investment. This will enable them to modernize and expand their industries and services to make them more competitive.

Alternative to Aid. This view is shared by many East Europeans themselves. Czech Finance Minister Vaclev Klaus, Polish President Lech Walesa, and Russian President Boris Yelstin repeatedly make the case for access to Western markets and increased Western private investment as an alternative to aid, which they view as detrimental to national pride and to economic development.

It is in America's political and economic security interests for the East Europeans, eventually including the former Soviet republics, to make the transition from command to market economies. As leader of the world's free market economic order, America should take the lead in opening markets for East European goods and in pushing for Western companies to do business in Eastern Europe. The Bush Administration should do this by adopting a five-plank program for promoting trade and investment in Eastern Europe and the former Soviet republics:

Plank #1: Offer to negotiate free trade agreements between the U.S. and the East European countries, including the former Soviet republics. This would increase trade with the region by encouraging increased American investment and offering Eastern countries secure access to the giant American market.

Plank #2: Lower U.S. trade barriers for goods and services from Eastern Europe and the republics and exempt their exports from all tariffs for five years. Unilaterally reduced trade barriers to Eastern products will provide East Europeans with markets for their products and help American consumers by lowering the price of imports.

Plank #3: Withhold U.S. funding for the new European Bank for Reconstruction and Development (EBRD) until the European Community (EC) agrees to reduce significantly trade barriers to Eastern Europe. This will press the EC, which has a tremendous political and economic stake in the EBRD, to open its markets to Eastern goods.

Plank #4: Allow for "tax sparing" with East European countries and former Soviet republics. The U.S. should follow the example of other industrialized countries like Germany and the Netherlands and spare its right to levy higher U.S. taxes on American multinationals when they are granted tax holidays by countries in Eastern Europe and the former Soviet Union. This would reduce taxes for many American firms in the region, thereby increasing American investment in the region.

Plank #5: Reduce taxes on Americans working in Eastern Europe and the republics. This would give a greater incentive for top American businessmen to spend more time in Eastern Europe, where their expertise is needed.

WHY AID DOES NOT SPUR ECONOMIC GROWTH

Despite a plethora of well-intentioned plans now being considered by Congress and the Bush Administration, foreign aid will not lift Eastern Europe and the Soviet Union out of the poverty caused by decades of communism. Most government assistance programs in fact do more harm than good. Generous food aid to Poland in 1989, for instance, impoverished thousands of Polish private farmers unable to compete with free food from the West. Due to Western generosity, Polish farmers had to stand by helplessly watching as their own grain and meat rotted for lack of demand.

Technical assistance programs, while better than most foreign aid programs, nevertheless also have a poor track record. According to World Bank officials, only three out of nineteen major technical assistance projects undertaken in Africa in the past five years have been even moderately successful in accomplishing their goals.[1] Government technical assistance projects in Eastern Europe appear to be doing little better. Poles and Hungarians frequently complain that the thousands of Western bureaucrats sent to advise them on matters ranging from en-

1 Laura Wallace, "Reshaping Technical Assistance," *Finance and Development*, December 1990.

vironmental regulation to democratic institutions are of little help because they often have limited knowledge of local circumstances.

Government-to-government loans and grants can be particularly detrimental to economic development. Grants often are used to subsidize inefficient state industries, reducing the incentive to undertake needed, if temporarily painful, free market economic reforms. Loans can saddle countries with enormous foreign debts, as Latin Americans and others painfully have learned. And, of course if countries default on loans guaranteed by the U.S. government, American taxpayers foot the bill. In addition to their economic costs, direct loans and grants have adverse political effects. Often, for example, loans to foreign governments reinvigorate the power of local government bureaucrats—in the East many of them communists—by giving them control over where aid is directed within the country.

Equal to Marshall Plan. Ignoring the lesson of foreign aid's dismal record, massive amounts of Western cash are flowing into Eastern Europe and the Soviet Union. Over $16 billion in bi-lateral and multi-lateral Western aid is targeted for Eastern Europe this year alone. This massive aid infusion is just about equal, when adjusted for inflation, to U.S. Marshall Plan aid to Western Europe after World War II.[2]

The popular myth is that the Marshall Plan was an unqualified success. The reality however is that the Marshall Plan had mixed results at best. Instead it was the economic policies pursued by European leaders such as West Germany's Ludwig Erhard and Italy's Luigi Einaudi that had the greatest impact on economic development in the region. Similarly, in Eastern Europe, the growth of market institutions will depend primarily on enacting the right economic policies, not foreign assistance.

TRADE AND INVESTMENT, RATHER THAN AID

Rather than pouring billions of dollars in government-to-government aid into Eastern Europe and the republics, the West better could promote economic development by taking steps to increase trade and investment. The new democracies are critically short of the hard currency needed to buy the machinery and Western high technology to modernize their economies. Increased investment will bring private capital to the region, and along with it the advanced technology and managerial expertise required for economic expansion. Reducing Western trade barriers will open markets for East European goods, thereby encouraging the growth of agriculture, private industry, and services. This in turn will lead to economic expansion and integration into the world economy.

2 Susan M. Collins and Dani Rodrik, *Eastern Europe and the Soviet Union in the World Economy* (Washington, D.C.: Institute for International Economics, May 1991), p. 85.

Western trade barriers remain a major impediment to expanding trade. A 1989 Agency for International Development study on foreign aid and economic development finds that Western trade protection reduces the national income of developing countries by an amount equal to twice the total aid sent annually from the developed to the developing world.[3] This costs the developing world between 2.5 percent and 9 percent of its total economic output and depresses developing country exports by over 10 percent.[4]

Free trade, of course, is a two-way street. It is equally important that Eastern Europe and the former Soviet republics reduce their own trade barriers to enjoy the benefits of freer trade, including steady growth. High tariffs and such non-tariff barriers as quotas and licensing fees impede economic development. They hurt Third World consumers, who then must pay more for foreign goods.

Higher Prices. Also hurt are Third World domestic businesses, which are forced to pay higher prices for imported supplies and raw materials. This makes them less competitive on international markets, decreasing exports. Trade barriers also reduce foreign investment, since fewer world-class business opportunities exist in slow-growing economies geared toward domestic markets.

The evidence now is indisputable that outward-oriented, free trade countries have higher economic growth rates than protectionist countries. A comprehensive 1987 World Bank study concludes that gross domestic product (GDP), manufacturing, and investment all grow faster in trade-oriented than in protectionist countries.[5]

Many East Europeans resist speedy trade liberalization because they erroneously believe that removing trade barriers will destroy local industries, create unemployment, lower government revenues, and lead to balance of payment deficits.

These concerns are contradicted by the empirical evidence. A World Bank study of nineteen countries, released in fall 1990, shows that the unemployment costs of broad trade liberalization are low and temporary, and are offset by increases in economic growth.[6] According to the study, moreover, lower tariffs actually can generate higher government revenues because taxable imports increase. This rarely results in serious balance of payment deterioration, since exports also rise quickly.

---

3 *Development and the National Interest: U.S. Economic Assistance into the 21st Century* (Washington, D.C.: United States Agency for International Development, February 1989). Hereinafter referred to as the Woods Report.

4 United Nations Conference on Trade and Development, "Protectionism and Structural Adjustment, Introduction and Part I," Geneva: January 1986.

5 World Bank, *World Development Report 1987* (Washington, D.C.: Oxford University Press, 1987).

6 World Bank, *Liberalising Foreign Trade in Developing Countries: The Lessons of Experience*, Washington, D.C.: October 1990.

Just as important as increased trade is increased Western investment. American and other Western firms can supply Eastern Europe with the capital needed to modernize their economies and gain access to new technology, entrepreneurial skills, managerial and marketing expertise, and jobs with higher wages. In contrast to government-to-government loans, a squandered investment by a multinational firm will be that firm's loss only; it will not be a loss for America's taxpayers.

In most of the less developed world, multinational corporations have been the most effective agents for economic development. Unlike government or international organization bureaucrats, businessmen must measure success or failure by a "bottom line," and tend therefore to invest their money far more carefully. When Western businesses go abroad, they bring with them the business, managerial, and job training skills that developing countries must adopt in order to compete on the world market. This already is happening in Eastern Europe where such American multinationals as International Business Machines, Incorporated, and General Electric Company have established extensive job and technology training programs.

THE ASIAN MODEL

The rapid development of East Asia's four "tigers"—Hong Kong, the Republic of China on Taiwan, the Republic of Korea, and Singapore—demonstrates the key role played by free trade and Western investment in economic growth. In the 1950s, the Pacific Rim was as poor as Africa, and America was pouring massive foreign aid into South Korea and Taiwan. Today, the Pacific Rim is approaching the living standards of Western Europe while Africa remains impoverished. One reason: the Asian Tigers kicked the foreign aid habit while Africa remains addicted.

American aid in the 1950s allowed Seoul and Taipei to pursue protectionist trade policies, imposing high tariffs and quotas in the knowledge that U.S. aid would cushion their economies from some of protectionism's worst effects. The same rationale led to heavy subsidies for domestic producers. The combination of trade barriers and subsidies made goods more expensive for consumers, hurt exports, and slowed economic growth. It appeared to many economists at the time that Africa in fact, with its abundant natural resources, had a much better chance for rapid economic development than resource-poor, slow-growing East Asia.[7]

In the early 1960s, however, the U.S. inadvertently did Taiwan and South Korea a favor by slashing foreign economic aid to them. Though political factors prompted the aid cutoff, the consequences were mainly economic. Seoul and Taipei dealt with reduced aid flows from the U.S. by removing many government

---

7 Edward L. Hudgins and Bryan T. Johnson, "Why Asia Grows and Africa Doesn't," Heritage Foundation *Backgrounder* No. 756, March 2, 1990.

controls from the economy. Trade was liberalized and subsidies were cut.[8] Ever since, Seoul and Taipei steadily have lowered trade barriers, in part to keep pace with Hong Kong and Singapore, whose open trade policies and unfettered economies have been magnets for Western trade and investment.[9]

Export Explosion. The result has been an export explosion for the region. In the 1970s, exports grew an average of 20 percent a year for Singapore; 31 percent a year for Taiwan; and 37 percent a year for South Korea.[10] This would not have been possible without access to Western markets, particularly to the American market. American consumers, for example, purchase 40 percent of everything that Taiwan and South Korea export.

Trade and investment alone were not responsible for economic development in East Asia. The Asian Tigers helped themselves enormously with economic policies that included low taxes, minimal government regulation, tight monetary policy, and realistic currency exchange rates. Taken together, these policies have led to more rapid economic growth than any other region in the world. In three decades, per capita income in the Asian Tigers increased 266 percent.[11] Already, East Asia is beginning to overtake parts of Western Europe: the average Hong Kong citizen, for example, today has greater purchasing power than the average Swede.

East Europeans have the resources and the educated and skilled work force needed to mimic the success of the Asian Tigers. To do so, they will need Western help in the form of open markets for East European goods and increased investment.

ACCESS TO MARKETS: THE KEY TO EXPANDING TRADE

Given market access, East European countries and the Soviet Union could double their share of world trade over the next two decades, according to a study by economists Susan M. Collins and Dani Rodrik. Their study predicts a drastic redirection of trade for East European countries and the Soviet Union away from each other and toward Western markets.[12]

As a percentage of their total exports, East European exports to the West are expected to increase from a current range of between 9 percent (Bulgaria) and 34 percent (Poland), to between 40 percent and 62 percent.

---

8 Alvin Rabushka, "Tax Policy and Economic Growth in Advanced Developing Nations," report prepared for the U.S. Agency for International Development, 1987, p. 344.

9 In South Korea, 95 percent of import licensing arrangements have been eliminated.

10 Peter L. Berger and Hsin-Huang Michael Hsiao, eds., *In Search of an East Asian Development Model* (New Brunswick, N.J.: Transaction Books, 1988), pp. 48-50.

11 Hudgins and Johnson, *op. cit.*, p. 4.

12 Collins and Rodrik, *op. cit.*, Chapter 2.

Europe, rather than the U.S. or Japan, will account for the overwhelming preponderance of this trade shift. If the EC opens its markets to Eastern Europe and the Soviet Union, trade with the East could rise from 4 percent of EC trade today to 25 percent within twenty years. Soviet and East European trade is predicted to rise only to between 6 percent and 9 percent of U.S. trade from its level of just over 1 percent today.[13]

The Economies of Eastern Europe

*CIA figures.
Note: Economic data unreliable. GNP estimates for 1988 from PlanEcon, 1991. World Bank estimates are significantly lower. Boundary representations are not necessarily authoritative.

Trade figures for 1990 and early 1991 tend to confirm the changing patterns predicted by Collins and Rodrik. Hungary, for example, increased its hard currency trade—mostly with the West—by 18 percent in 1990 and 40 percent in the first quarter of this year. Most of the increase was due to the boost in exports by newly created small- and medium-sized Hungarian private companies, which are proving their ability to react more quickly than giant state industries to the collapse of Soviet trade and the decline of East European markets.

Pleading Desperately. The problem is that it is far from certain that the West, particularly West Europe, will open its markets to East European products. EC trade barriers keep out products from the East despite desperate pleas for trade liberalization from Vaclev Klaus, Lech Walesa, and other East European leaders. Complains Rita Klimova, Czechoslovakia's Ambassador to the U.S., "The EC is talking about environmental cooperation and cultural exchanges, but on the issue of trade, they're relegating it to the end of the century."[14]

Due to inferior technology, most East European and Soviet industrial, high-tech and consumer goods cannot compete in Western markets. Ironically, and not accidentally, it is in precisely these sectors that the European Community has eliminated most non-tariff trade barriers, such as quotas.

By contrast, in sectors where East Europeans often enjoy a comparative advantage due to cheaper labor costs, lower land values, and other reasons—including agriculture, clothing, steel, and textiles —the European Community has

---

13 *Ibid.* pp. 44-48.
14 *Wall Street Journal*, July 25, 1991.

erected very high barriers. If the market alone were the arbiter, according to David Roche, chief strategist with Morgan Stanley Company in London, there would be a major transfer of production from Western Europe to the East in these sectors.

Most troubling surely is the EC's notorious Common Agriculture Policy (CAP). An anti-competitive program managed by the EC's Brussels bureaucracy, the CAP mandates high tariffs on agricultural goods imported by the EC while providing export and production subsidies for EC farmers' products.[15] If it were not for the CAP, several East European countries, particularly Poland, and eventually Ukraine, could be major agricultural exporters to the EC.

Dumping of Products. In addition to blocking agricultural imports into Western Europe, CAP subsidies mean that EC agricultural products are dumped onto East European markets at below-market prices, hurting local production. This has caused tremendous political problems for the East European governments. In summer 1991, for instance, Czech farmers went on strike and blocked border crossings to protest the import of subsidized EC food.

The European Community currently is nearing agreement with Czechoslovakia, Hungary, and Poland to make these nations "associate members" of the EC and to ease trade barriers. The association agreements, however, at least in the short term, will keep many barriers in place. EC quotas and duties on steel will be lifted within five years and tariffs on textiles within ten years for the associate members. Tariffs on meat will be somewhat lowered, but farm products will continue to be heavily protected by the CAP. Germany still is demanding import restrictions to keep out East European coal.

Too Long a Wait. East Europeans cannot wait five to ten years for a partial opening of the West European market. The collapse of trade with the Soviet Union and disintegrating intra-East European trade make it imperative that markets for their goods open immediately. Laments Vladimir Dlouhy, Czechoslovakia's economics minister, "I don't need support [reducing trade barriers] in five years. I need it now and terribly so."[16]

One effect of the EC's refusal to eliminate trade barriers quickly is that East European countries are likely to start raising their own tariffs in response, reversing the welcome trend toward trade liberalization. Hungary this year cut average tariff rates from 16 percent to 13 percent, bringing them more in line with other developed countries.[17] License requirements for the import of Western goods also have been cut by Hungary; they are now required for only 10 percent of imports, and 99 percent of applications were approved last year.

---

15 For more information on the CAP, see Ewen M. Wilson, "The European Community's Common Agricultural Policy: Continued Problems for the U.S.," Heritage Foundation *Backgrounder* No. 799, December 5, 1990.

16 "East Looks West and Sees Trade Barriers," *Wall Street Journal*, July 25, 1991.

17 "Hungarians allow most curbs on imports to lapse," *Financial Times*, April 10, 1991.

Poland, meanwhile, last year eliminated import quotas; most duties were lowered to zero or five percent, and tariffs were removed altogether on about 58 percent of goods coming into the country. Partly as a result of the trade liberalization, Polish companies bought cheap imported components and thus reduced costs. The result: Polish businesses increased exports 50 percent last year.

Swinging Pendulum. But now the pendulum is swinging the other way. This April, Poland raised the average customs tariff on agricultural goods from 9.8 percent to 19.3 percent and duties on finished tobacco products from 30 percent to 60 percent.

For its part, the U.S. has moved further and more quickly than the EC to reduce barriers to East European exports. George Bush's Trade Enhancement Initiative for Central and Eastern Europe, for instance, grants duty-free benefits to some categories of East European exports and funds seminars for East European officials on U.S. trade laws. Further, in the past two years, Washington has granted what is known as "Generalized System of Preferences" (GSP), allowing $500 million in East European goods to be exported to the U.S. free of duty charges. An additional $182 million in GSP benefits for Eastern Europe were approved in March.[18]

While helpful, these measures are of limited assistance to East European countries since by law they exclude the very sectors in which the highest barriers already exist: cheese, clothing, steel, and textiles. In July, Bush announced that special trade preferences would be granted to Czechoslovakia, Hungary, and Poland in the food and textile sectors. All former East bloc countries except Albania and Romania now have been granted Most Favored Nation (MFN) status by the U.S., meaning they all receive the benefits of the same low tariffs extended to more than 150 countries. Steel quotas will be removed next year and textile quotas have been eased, although political opposition from textile states makes complete elimination of the quotas unlikely. Meanwhile quotas on clothing, a major potential East European export, remain intact.

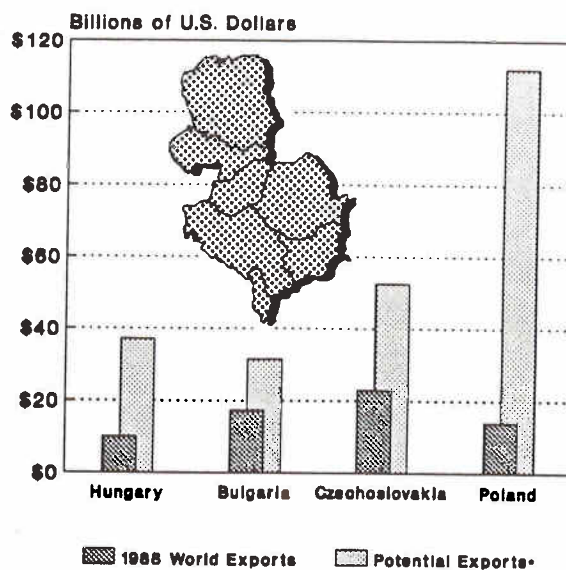
FOREIGN INVESTMENT INCREASING SLOWLY IN EASTERN EUROPE

Since communism collapsed in 1989, Eastern Europe has attracted over $1.5 billion in Western private investment. PlanEcon, a Washington, D.C.-based consulting firm, estimates that by 1993, Czechoslovakia, Hungary, and Poland combined could be getting $3.2 billion a year in foreign investment.[19] After a very slow start, American companies are beginning to invest greater amounts of capital in the region.

18 Poland will receive $93.3 million of the benefits, thereby doubling Poland's duty-free exports.

19 *PlanEcon Report*, various issues, Washington, D.C.

American firms overtook the Germans last year as the top investors in Hungary. Over 4,500 joint American-Hungarian ventures have been registered; American giants Ford Motor Company, General Electric Company, General Motors Corporation, and Sara Lee Corporation plan a combined $440 million in investments in Hungary. American institutional investors, too, are putting money in Hungary. Americans recently bought about half the $14.3 million shares available in a stock offering of Fotex Corporation, a Hungarian conglomerate with a chain of photo labs, eyeglass stores, and crystal shops.



U.S. business investment also is picking up in Poland. American investors accounted for 11.3 percent of the new foreign businesses registered there in 1990, twice the level of 1989.[20] Over 214 American firms, with investments of over $58 million, now are registered in Poland. Still, this is a relatively small share of the $400 million in foreign direct investment that flowed into Poland in just the first quarter of 1990.

Like Asian Tigers. If East Europeans and the Soviet republics are to duplicate the rapid economic growth of the Asian Tigers, they must attract far greater levels of private investment from America and other Western countries. Important steps in this direction already have been taken by the East Europeans themselves. Western companies now are permitted by Hungary and Poland to take their profits out of the country. Tax incentives and legal investment guarantees increasingly are being offered to foreign businesses. Czechoslovakia, Hungary, and Poland, for instance, all offer "tax holidays" to foreign businesses. Most of the East European countries already, or soon will, permit majority foreign ownership of newly privatized companies—a complete turnaround from the xenophobia of the communist era.

20 "Situation Report-Poland: January-February 1991," U.S. Chamber of Commerce, International Division, p. 5.

There remain, however, significant obstacles to doing business even in Hungary and Poland. Telecommunications systems remain unreliable and of poor quality. Modern banking systems are not yet in place. Laws governing ownership and the transfer of property still are confused, while most industries remain in state hands. Bureaucratic obstacles abound and currencies are not yet fully convertible on international markets.

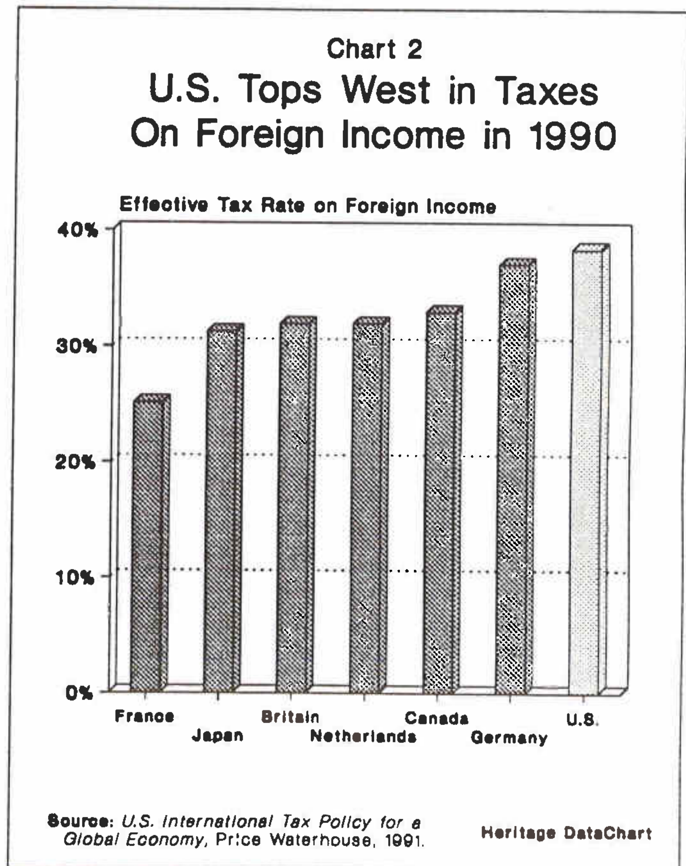
East European Role. Responsibility for increasing foreign direct private investment rests mainly with the East Europeans themselves. If they continue their march toward free market economies, foreign investment will follow. Still there is much that America and Western Europe can do.

The Bush Administration already has moved to increase American investment in Eastern Europe. A Bilateral Investment Treaty still under negotiation with Czechoslovakia, for instance, will give American investors such basic guarantees as equal treatment with local companies. It also will allow full "repatriation" of profits to the U.S. A similar treaty is being negotiated with Bulgaria. Last year, the U.S. Senate ratified a Business and Economic Relations Treaty with Poland which, along with the guarantees of a Bilateral Investment Treaty, also protects intellectual property rights, like patents.

U.S. TAX LAWS BARRIER TO INVESTMENT

One serious remaining obstacle to American investment in Eastern Europe is the U.S. tax code. For nearly the first half-century after the adoption of the corporate income tax in 1913, American companies paid lower taxes relative to other countries on income earned abroad. In this period, as a result, American companies were highly competitive globally.

Starting in the early 1960s, however, tax laws were made ever more complicated, eroding the tax advantage American companies enjoyed over other multinationals. The average effective tax rate on income earned abroad for U.S. companies is 38 percent. This is



higher than the rate paid by companies based in any of the six other major industrial countries. Over the past thirty years, Germany, the Netherlands, and other Western countries have revised tax laws to encourage their companies to compete internationally. America has moved in the opposite direction.[21]

No Tax Holidays. One of the most anti-foreign-investment aspects of the U.S. tax code is that it does not permit American companies to take advantage of many incentives to attract investment offered by foreign governments, including the East European. Among these are "tax holidays," which exempt foreign multinationals from all local taxes for periods of up to ten years; Poland automatically grants joint ventures with foreign investors a three-year tax holiday.

The U.S. tax code requires American companies operating abroad to pay foreign taxes on corporate profits. Then, if the foreign tax is lower than the U.S. corporate profits tax, the difference between the two taxes must be paid to the U.S. Treasury. If the foreign tax rate is cut, therefore, the company receives no benefit because it simply pays more to U.S. tax collectors. Even if a foreign country's tax rate drops to zero, as it does during a tax holiday, the effective tax rate for the U.S. company is not lower. The firm simply pays the full amount to the U.S. government. Other industrial nations allow for what is called "tax sparing." By this, the governments "spare" or "forgive" the right to levy their full tax on a company if it takes advantage of a "tax holiday" or similar incentive.

Forbidding Tax Sparing. Tax sparing encourages firms to do business overseas, thereby assisting in Third World economic development and at the same time making Western businesses in those countries that allow it more competitive and profitable. By forbidding tax sparing, the U.S. undermines the competitiveness of Americans own companies vis-a-vis other Western companies.

A study by the Washington-based Tax Foundation finds, for example, that a German firm operating in Singapore would have a 24 percent advantage in cash flow over an American firm; a Japanese firm would have a 32 percent advantage. The reason: tax sparing. Germany and Japan have tax sparing agreements with Singapore; America does not.[22]

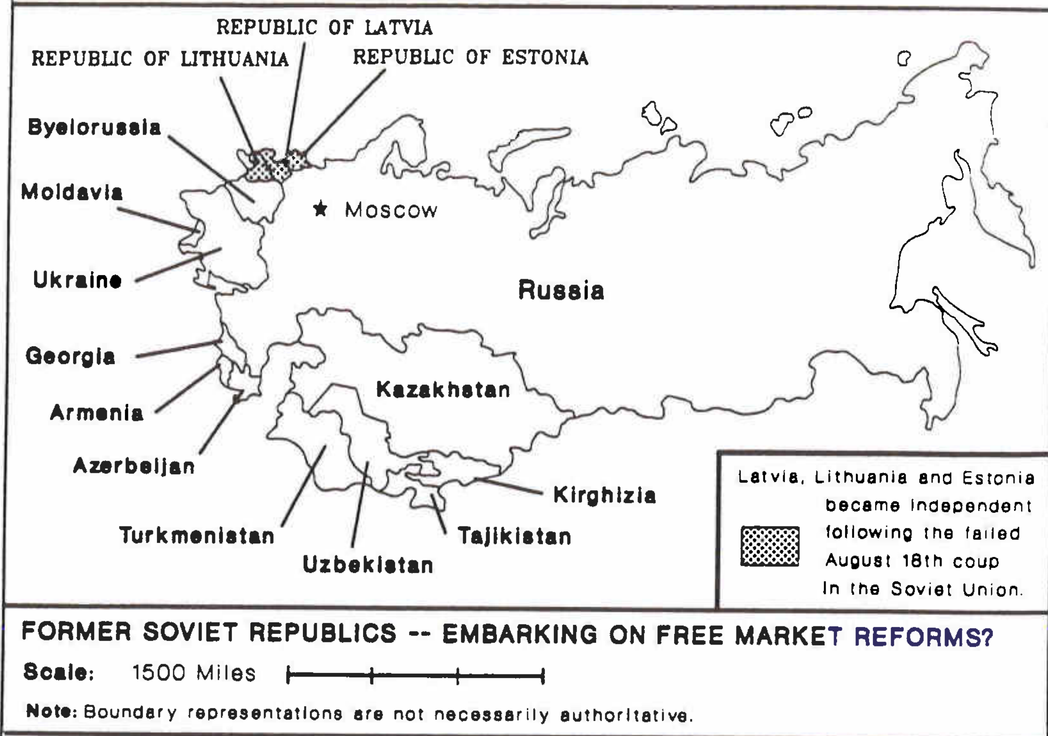
Income Tax Earned Abroad. Another example of how U.S. tax laws discourage American companies from investing and operating abroad is the individual income tax. The U.S. is the only major industrialized country that taxes individual income earned abroad. As a result, West Europeans or Japanese work-

---

21 See, for example, *The Competitive Burden: Tax Treatment of U.S. Multinationals*, prepared for the Tax Foundation by Arthur Young and Company, Washington, D.C., 1988; Norman B. Ture, "EC92's Implications for U.S. Foreign Tax Policy, " testimony to the House Committee on Ways and Means, January 30, 1990; and *Competitive Tax Disadvantages Faced by U.S. Multinationals*, A Tax Foundation Special Report, Washington D.C., 1990.

22 *Competitive Tax Disadvantages Faced by U.S. Multinationals*, A Tax Foundation Special Report, Washington D.C., 1990.

ing in Eastern Europe pay only local income taxes. Americans, by contrast, pay U.S. taxes in addition to local taxes on incomes above $70,000.



FORMER SOVIET REPUBLICS -- EMBARKING ON FREE MARKET REFORMS?

This discourages higher-paid, senior American executives from working in Eastern Europe and elsewhere in the developing world. This, in turn, makes it more costly and more difficult for U.S. firms to compete globally, thereby decreasing competitiveness and ultimately investment. The tax burden imposed on Americans working abroad also costs the U.S. exports. According to a 1980 Chase Econometrics study, U.S. exports decline by 10 percent for every 10 percent reduction in American workers overseas.[23]

A FIVE-PLANK PROGRAM TO INCREASE TRADE AND INVESTMENT WITH EASTERN EUROPE AND THE REPUBLICS

For Eastern Europe and the former Soviet republics to succeed in their transformation to free market economies, their trade with the West and their ability to attract foreign investment must increase dramatically. Yet, so far, doors to Western markets remain tough to pry open, while foreign investment is limited. Sweeping initiatives are needed by the U.S. and Western Europe to open markets to East European goods and to clear the way for increased Western investment. The U.S. already has made progress. Further steps will signal the East Europeans and former Soviets that Americans, unlike many West Europeans, have confidence in

23 Robert D. Shriner, "Taxation of U.S. Workers Overseas Hurts Workers, Firms and Exports," Chase Econometrics, *U.S. Macroeconomic Forecast and Analysis*, May 1981, pp. A30-A37.

Eastern Europe's ability to transform its economy. George Bush should help the East Europeans and former Soviet republics to help themselves by unveiling a five-plank program for promoting increased trade and investment in the region. The program:

Plank #1: Offer to negotiate free trade agreements between the U.S. and the East European countries, including the former Soviet republics.

Just when the countries of Eastern Europe most need free trade, they are being met with resistance, especially by the European Community. An offer to negotiate a free trade area with the U.S. would give East Europeans leverage against the EC by offering them an alternative economic partner. It also would encourage American investment in Eastern Europe and give East Europeans access to the American market. It further would ensure that when East-West European trade barriers finally are dropped in ten years, America would not be isolated, stuck with high barriers to trade with both the EC and East Europeans.

Free trade arrangements (FTAs) with Eastern Europe and the republics would remove obstacles to trade such as tariffs, as well as nontariff trade barriers like import licensing, trade quotas, and subsidies. There are other potential benefits that can and should be negotiated in FTAs. Restrictions on foreign investments can be eliminated, intellectual property agreements that protect American companies' patents and copyrights can be strengthened, and trade conflicts, such as those over anti-dumping laws, can be reconciled by creating a trade dispute resolution process. The U.S. has FTAs with Canada and Israel and is negotiating an FTA with Mexico. FTAs offer more short-term advantages than the higher tariffs and barriers offered by "association" status with the EC, and would benefit East Europeans over the long term since they would force the EC to open its own markets to compete on equal terms with America.

Plank #2: Lower U.S. trade barriers for goods and services from Eastern Europe and the republics and exempt their exports from all tariffs.

Free trade negotiations with the East Europeans could take several years, given their political complexities. Immediately, however, the U.S. can move unilaterally to reduce trade barriers to products from Eastern Europe and the former Soviet republics. Barriers should be removed, or lowered substantially, to the import of cheese, clothing, steel, and textiles. These are some of the most heavily protected U.S. markets, but also are the sectors in which Eastern products have the best chance to compete in the American market.

The critical first step is to eliminate customs duties on imported goods from Eastern Europe. The U.S. in the last two years already has granted $682 million in "Generalized System of Preferences," allowing East European goods to be imported into the U.S. duty free. While helpful, these measures are of limited assistance to East European countries since by law they exclude the very sectors in

which the highest barriers already exist, including again, cheese, clothing, steel and textiles.

Bush announced at the July Western industrialized nations Group of Seven (G-7) economic summit in London that Czechoslovakia, Hungary and Poland would be granted special trade preferences in the food and textile sectors. Quotas are to be increased on textiles while more agricultural goods are to be eligible for GSP preferences. Bush should take this one step farther by calling for an East European Trade Preference Act which eliminates duties on all goods from Eastern Europe for five years. This would open a huge market for East European exports, thereby encouraging the rapid development of dynamic private sector businesses with exporting potential.

Plank #3: Withhold U.S. funding for the New European Bank for Reconstruction and Development (EBRD) until the European Community agrees to reduce significantly its trade barriers to East European products.

Dismayed by the European barriers to trade with the East, voices in Europe are calling for trade liberalization. Jürgen W. Mollemann, the German Economics Minister, advocates the elimination of quotas on East European goods and the elimination of subsidies for EC producers, including farmers. In a speech to his cabinet, German Chancellor Helmut Kohl on October 13 endorsed Molleman's proposals. Britain and Denmark also have called for rapidly opening markets to Eastern Europe. An EC Commission report released last month urges the EC to increase access for East European goods to EC markets. Major opposition, predictably, is coming from traditionally protectionist France. As such, the EC is not taking the advice of its own experts.[24] The Bush Administration too repeatedly has pressed the EC to reduce trade barriers to Eastern Europe, but to little avail. The EC needs to be pushed harder.

Aid to Transition. One lever Washington holds for this is the U.S. contribution to the European Bank for Reconstruction and Development (EBRD). The EBRD was created in early 1990 to assist the East European transition to democracy and market economies. EC members hold 51 percent of the shares in the bank, although the U.S. is the largest individual country shareholder with 10 percent. Funds for the bank are contributed by member countries proportionate with their voting shares. This amounts to a $1.2 billion contribution from the U.S. Of this, 30 percent, or $365 million, must be contributed in cash, while the remainder would be "callable" when needed.

Headed by French socialist Jacques Attali, the EBRD began operations this fall, with $12.2 billion to aid Eastern Europe and the Soviet Union. One-quarter of the bank's budget will go to the 23 well-paid, full-time directors of the Bank, largely bureaucrats and ex-politicians.[25]

24 *Wall Street Journal*, July 30, 1991, p. A13.

Due to American insistence, 60 percent of EBRD loans will go to Eastern Europe's growing private sector, rather than to governments. Firms that produce textiles and process food should be prime candidates for loans from the bank. These loans will do little good, however, unless new businesses in Eastern Europe have access to EC markets for their products. Bush and Congress should refuse to approve of the scheduled American contribution to the European-controlled development bank until Western Europe eliminates or greatly reduces its trade barriers to East European products, including opening its markets to Eastern agricultural goods.

Plank #4: Allow for "tax sparing" with East European countries and former Soviet republics.

East European countries, desperate for Western capital and know-how, are granting generous tax holidays to foreign companies. The tax laws of many developed countries allow their multinational corporations to take advantage of tax holidays. In these cases, the developed country spares the multinational firm the obligation of paying higher taxes in its home country when their foreign taxes drop. This is not so for American companies, which simply have to pay higher U.S. taxes when their foreign taxes are lowered. This hurts the American competitive position vis-a-vis other Western multinational corporations.

Toward a Level Playing Field. Tax sparing for American corporations, instituted in the form of treaties between the U.S. and East European governments, would promote increased American investment in Eastern Europe and level the playing field for American companies in relation to other Western corporations. Representative David Dreier, the California Republican, will introduce a bill this month known as PROGRESS. It would authorize the President to allow for tax sparing for U.S. companies operating in Eastern Europe.

If it approves tax sparing, Congress would expand opportunities for U.S. businesses and increase U.S. direct investment in Eastern Europe and former Soviet republics. Bush should join Dreier in calling on Congress to change the formula in the U.S. tax code that deals with the treatment of foreign source income to allow for tax sparing.

According to Stephen J. Entin, resident scholar at the Institute for Research on the Economics of Taxation in Washington, D.C., tax sparing will not affect the 1990 budget agreement between the White House and Congress nor will it hurt the U.S. budget deficit.[26] The reason: U.S. businesses have not actually invested a great deal of money in the region and it will likely take some time to realize substantial profits. Therefore the Treasury Department's estimates for tax revenues from profits in the region should be near zero anyway.

---

25 "A bank in the hand," *The Economist*, April 13, 1991, pp. 14-15.

26 Stephen Entin, "Aid to East Bloc—A Taxing Question," *Wall Street Journal*, September 5, 1991.

Much of the U.S. investment in Eastern Europe and profits that would be produced from the investments would not take place without the tax sparing incentive. Therefore, tax sparing would have no real revenue cost under the revenue estimating rules employed for budget projections and could be enacted without the tax increases or spending reductions mandated in the restrictions of the 1990 Budget Act.

According to a January Price Waterhouse study, the value of international trade as a percentage of U.S. national income has doubled over the past four decades. The share of U.S. corporate earnings produced by foreign affiliates has tripled, now accounting for 43 percent of the worldwide profits of American multinational corporations.[27] With international trade becoming increasingly vital to the health of American businesses, the U.S. no longer can afford to pursue tax policies that put its companies at a disadvantage in the global marketplace.

Plank #5: Reduce taxes on Americans working in Eastern Europe and the republics.

Alone among major industrial nations, the U.S. taxes its citizens who work abroad. Americans who earn more than $70,000 must pay U.S. taxes in addition to foreign taxes. The resulting heavy tax burden discourages individuals making more than $70,000 per year, mainly high-level U.S. business executives with precisely the skills needed in Eastern Europe, from spending much time working there.

The U.S. should be encouraging American firms to operate in Eastern Europe, not discouraging them with high taxes.

Dreier's PROGRESS bill proposes doubling to $140,000 the amount of foreign source income that can be exempted from U.S. personal income taxes. This would offer powerful incentives for senior, experienced American businessman to spend more time in Eastern Europe, where opportunities for entrepreneurship and investment abound, and where their managerial expertise and skills in finance and business would be extraordinarily valuable in assisting local businesses to adapt to free market conditions.

CONCLUSION

After decades of isolation, East Europeans and the peoples of the dying Soviet Union want to develop free market economies and join the world economy. Experience in the developing world demonstrates that foreign aid is the wrong prescription both for economic growth and expanding trade. Instead, as

27 *U.S. International Tax Policy For A Global Economy*, prepared for National Chamber Foundation by Price Waterhouse, Executive Summary, January 11, 1991, p. e-3.

demonstrated in Africa, foreign aid breeds a destructive cycle of dependency and ever increasing need.

The remarkable rise of the Asian Tigers — Hong Kong, the Republic of China on Taiwan, the Republic of Korea, and Singapore — offers a lesson for Eastern Europe and the former Soviet republics: rapid growth in exports and large infusions of foreign business investment are far more important than government-to-government aid in sparking rapid growth.

At the London economic summit in July, the leading industrial countries endorsed this prescription, formally declaring that "expanding markets for [Eastern Europe's] exports is vital." Yet, despite the rhetoric, there are few signs that Western trade barriers to East European goods soon will fall. Increases in energy prices and the collapse of Soviet and intra-East European trade have created a dire economic situation in Eastern Europe and the republics of the former Soviet Union. The situation requires the U.S. and other industrialized nations to match their rhetoric with action. U.S policy should promote free trade, free markets, and increased Western investment in the East.

Lowering Barriers. A first step should be for the U.S. to offer free trade agreements to East European countries and former Soviet republics. In the meantime, trade barriers should be lowered and East European and republic goods should be let into America free of duty charges for five years. The U.S. also should press the European Community to reduce its own stiff trade barriers to Eastern Europe. One way would be to withhold funding from the European Bank for Reconstruction and Development (EBRD) until the EC opens its market to East European agriculture, steel, textiles, and other "sensitive" goods.

To increase American business investment in Eastern Europe and the republics, the U.S. should negotiate tax sparing treaties with East European countries and liberated republics, and reduce taxes on Americans working in the region.

The countries of Eastern Europe deserve to follow the high-growth path of the Asian Tigers and reach the levels of prosperity enjoyed in Western Europe. Toward this end, these countries are adopting free market reforms such as freeing prices, tightening the money supply, eliminating subsidies to state enterprises, and privatizing and deregulating industry. Even with these reforms, however, the East could fail unless the West opens its markets and takes steps to encourage private investment in the East. It now, therefore, is the time for America and the rest of the industrialized world to assist them in their bid for prosperity and independence by helping East Europeans to help themselves.

William D. Eggers
Policy Analyst

All Heritage Foundation papers are now available electronically to subscribers of the "NEXIS" on-line data retrieval service. The Heritage Foundation's Reports (HFRPTS) can be found in the OMNI, CURRNT, NWLTRS, and GVT group files of the NEXIS library and in the GOVT and OMNI group files of the GOVNWS library.