Backgrounder
Published by The Heritage Foundation
No. 1781
July 23, 2004

The United States Is No Longer the Champion of Economic Freedom

Ana Isabel Eiras

We Americans love to be champions: champions of the Olympics, champions of democracy, champions of the world. For the most part, we are pretty good at it. However, for the last 10 years, America has been losing the championship of economic freedom. According to the *2004 Index of Economic Freedom,*[1] published by The Heritage Foundation and *The Wall Street Journal*, nine other countries—Hong Kong,[2] Singapore, New Zealand, Luxembourg, Ireland, Estonia, the United Kingdom, Denmark, and Switzerland—are now ranked above the United States.

The United States is losing ground on economic freedom for two reasons: First, other countries are freeing their markets at a faster pace than the U.S. Second, the United States is simultaneously burdening its own economy with increasingly higher government expenditures and barriers to trade and investment. This is not something to take lightly. Economic freedom is the foundation of U.S. economic strength, and economic strength is the foundation of America's high living standards, military power, and status as a world leader.

The U.S. government should take steps to reverse this slide in economic freedom. To that end, the Bush Administration and Congress should cut expenditures to balance the federal budget; eliminate agricultural subsidies, anti-dumping provisions, and other protectionist policies; and continue to support the expansion of free trade. More economic freedom at home will assure that a healthy U.S. economy remains the solid basis of U.S. prosperity and strength.

Talking Points

- Since The Heritage Foundation began assessing economic freedom 10 years ago, the United States has dropped from the 4th freest economy to the 10th. In nine countries, the opportunities for generating wealth are now more abundant than in the United States.
- The United States is losing ground on economic freedom for two reasons: (1) Other countries around the world are freeing their markets faster than the United States; and (2) the United States is simultaneously burdening its own economy with increasingly higher government expenditures and barriers to trade and investment.
- "Money talks," both for individuals and for countries. As a country becomes wealthier, it has more resources to invest in national defense and health care. The wealth of a country makes it a world player, a leader that can shape world affairs. Preserving economic freedom is the key to being wealthy, prosperous, and powerful.

This paper, in its entirety, can be found at:
www.heritage.org/research/tradeandforeignaid/bg1781.cfm

Produced by the Center for International Trade and Economics (CITE)

Published by The Heritage Foundation
214 Massachusetts Avenue, N.E.
Washington, DC 20002–4999
(202) 546-4400 heritage.org

Lose Freedom, Lose Prosperity, Lose Power

Simply put, economic freedom is a measure of how unconstrained ordinary people are to engage in all levels of economic activity—from starting a business to opening a bank account to using a credit card; from buying groceries, traveling, and fixing their homes to being able to obtain good health care; from buying a car, sending their kids to school, and finding a job to counting on sound law enforcement and courts to protect their personal liberties and private property. The fewer obstacles to these activities that exist, the more people can participate in the economy—working, investing, saving, and consuming. The freer the economy, the more it surges, putting money in the pockets of millions of people and thus increasing the wealth of the country.

"Money talks," both for individuals and countries. As a country becomes wealthier, it has more resources to invest in national defense and health care. More goods and services are purchased and sold to every corner of the world. The wealth of a country makes it a world player, a leader that can shape world affairs. Preserving economic freedom is the key to being wealthy, prosperous, and powerful.

Measuring Economic Freedom

The *Index of Economic Freedom* provides a framework for measuring economic freedom by identifying the most important components of economic freedom and determining how each country measures up, factor by factor. In other words, the *Index* is a road map that, when followed closely, leads to wealth, economic stability, and influence on the world stage.

The *Index* assesses economic freedom in 10 different areas[3] of the economy:

- Trade policy (tariffs and non-tariff barriers);
- Fiscal burden (taxes and government expenditures);
- Government consumption;
- Monetary policy;
- Banking and finance regulations;
- Capital flows and foreign investment regulations;
- Wages and prices regulations (including subsidies);
- Protection of property rights;
- Regulations to start a business, including labor and environmental regulations; and
- Informal market activity.

Each country is scored on each of the 10 areas using a scale from 1 to 5—with 1 being freest and 5 being repressed. The average of a country's 10 scores is the "country score," which is used to place the country in one of four categories of economic freedom: free, mostly free, mostly unfree, and repressed. These four categories are an initial snapshot of how difficult (or easy) it is for ordinary people to do business in a country. The overall ranking of that score in the *Index* indicates how the business environment in that country compares to the rest of the world.[4]

A "free economy" should have a score of 1 or 2 in *all* 10 areas of economic freedom. Only in a free economy do people face minimal barriers to realizing their full potential, making money, and prospering. As the economy goes from "free" to "mostly free" or from "mostly free" to "mostly unfree," the barriers increase, which means that there are fewer opportunities for individuals to make money, because working and doing business become more

1. Marc A. Miles, Edwin J. Feulner, and Mary Anastasia O'Grady, *2004 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2004), at *www.heritage.org/research/features/index/downloads.html*.
2. Hong Kong is a special administrative region of the People's Republic of China; however, for the sake of simplicity and because it enjoys a high degree of autonomy, it will be referred to as a separate "country" throughout this paper.
3. For detailed information about the variables studied in each of the 10 areas of economic freedom, see William W. Beach and Marc A. Miles, "Explaining the Factors of the *Index of Economic Freedom*," Chap. 5 in Miles *et al.*, *2004 Index of Economic Freedom*, pp. 49–70.
4. Miles *et al.*, *2004 Index of Economic Freedom*.

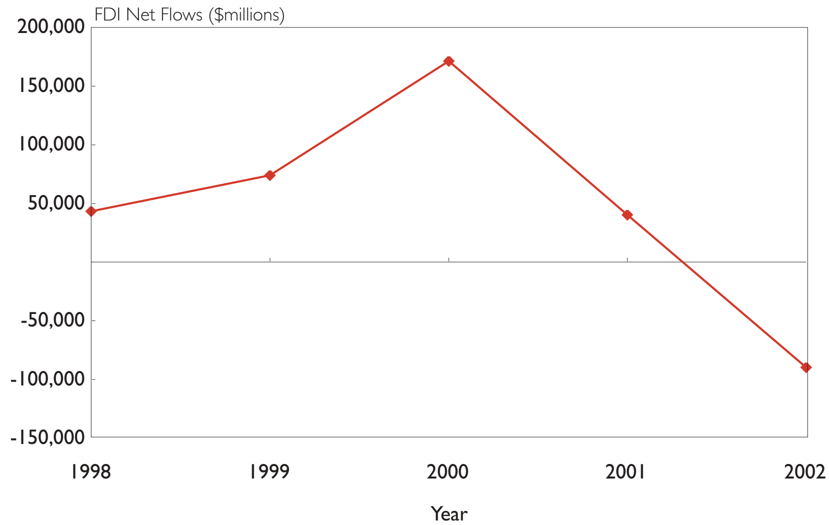
difficult. The people have the same desires, skills, and abilities, but the opportunities to employ them become harder to find. As a result, the country becomes increasingly poor.

Today, the United States is a free and rich country. It has, however, suffered a relative loss of economic freedom in the past 10 years. In the 10 years during which The Heritage Foundation has been assessing economic freedom, the U.S. has dropped from the world's fourth freest economy to the tenth.[5] In nine countries, the opportunities for generating wealth are more abundant than in the United States.

As a result, opportunities to invest, work, and do business have moved outside the United States. As Chart 1 shows, the net inflow of foreign direct investment (FDI)—i.e., total inflow minus total outflow—in the United States has declined sharply since 2000. According to Table 1, on p. 4, in 2002 the United States had the largest negative FDI flow relative to the nine freer economies in the world. Ireland, in contrast, had the largest positive FDI flow.

Chart 1 B 1781

Net Flows of Foreign Direct Investment in the United States (1998–2002)



Source: United Nations Conference on Trade and Development.

Losing economic freedom has important implications for the pockets of U.S. families, the coffers of the U.S. economy, and America's ability to remain a strong world leader. If America continues to fall behind, the value of the U.S. dollar could continue to decline. Americans will then have fewer opportunities to improve their lives and foreigners will find investing in the United States less and less attractive. As the U.S. economy weakens and other countries' economies strengthen, the United States' leadership and power in the world decline as well.

Why America Is Falling Behind

The United States is losing the economic freedom race for two reasons. First, the U.S. government's continued expansion of expensive entitlement programs has increased the fiscal burden. Second, other important areas of economic openness—capital flows and foreign investment, trade policy, wages and prices, and regulations—have simply failed to maintain pace with the changing world.

Increasing Government Expenditures. The *Index* measures the fiscal burden of government by the year-to-year change in government expenditures plus top marginal corporate and personal income tax rates. This is an area in which the United States is in a free fall. While the overall economic freedom position of the United States is 10th among 161 countries, when ranked solely in terms of fiscal burden, the U.S. plummets to 103rd place—23 places behind Germany, one place behind Denmark, one place ahead of Sweden, and two places ahead of Norway. By contrast—again in terms of the fiscal burden—Hong Kong is 6th, Ireland is 12th, and Chile is in 22nd place.[6]

5. *Ibid.*

Specifically, high U.S. corporate tax rates[7] are negatively affecting investment. The U.S. ranks a dismal 107th out of the 161 countries surveyed in the 2004 *Index*, meaning that 106 countries have a lower corporate tax rate. To make matters worse, rising government spending has already caused the United States to fall behind other countries, and this situation promises to worsen as the massive commitments of entitlement programs (e.g., Social Security and Medicaid) come due, including the new drug prescription benefit passed by Congress and signed by President George W. Bush in 2003.

Why has the fiscal burden of government in the United States gotten out of hand? Brian Riedl, a budget expert at The Heritage Foundation, has identified several reasons. First, despite $110 billion saved due to a drop in net interest payments on the national debt, the federal budget for fiscal year (FY) 2003 was $353 billion above the 1998 level.[8] This means that federal spending represented $20,300 per household in FY 2003, while taxpayers paid an average of $16,780 per household in taxes. The difference ($3,520) is the per-household portion of the federal deficit for FY 2003, which will be paid with higher taxes in the future.[9]

For many, the events of 9/11 and the need for a stronger national defense justify an extraordinary and unexpected increase in the government's budget. Ironically, however, the majority of the government's spending spree since 2001 is unrelated to 9/11 and national defense.[10] (See Chart 2.)

Spending has increased in almost all federal budget categories since 1998, but the fastest growing categories (outside of 9/11 response and defense) include:

- **Unemployment compensation**, which increased by 132 percent to $56 billion because of rising unemployment and the several extensions of unemployment benefits passed by Congress;
- **Education spending**, which increased by 78 percent to $58 billion, mostly due to the No Child Left Behind Act;
- **Health programs** outside Medicare and Medicaid, which increased by 81 percent to $60 billion; and
- **Agricultural subsidies**, which increased by 76 percent to $23 billion.[11]

Table 1 B 1781

Net Flows of Foreign Direct Investment

Country/Group	2002
Ireland	$16,327
Singapore	$3,573
Denmark	$1,115
Estonia	$185
New Zealand	$44
Switzerland	-$2,484
Hong Kong (China)	-$3,976
United Kingdom	-$14,759
Luxembourg	-$28,413
United States	-$89,711

Source: United Nations Conference on Trade and Development.

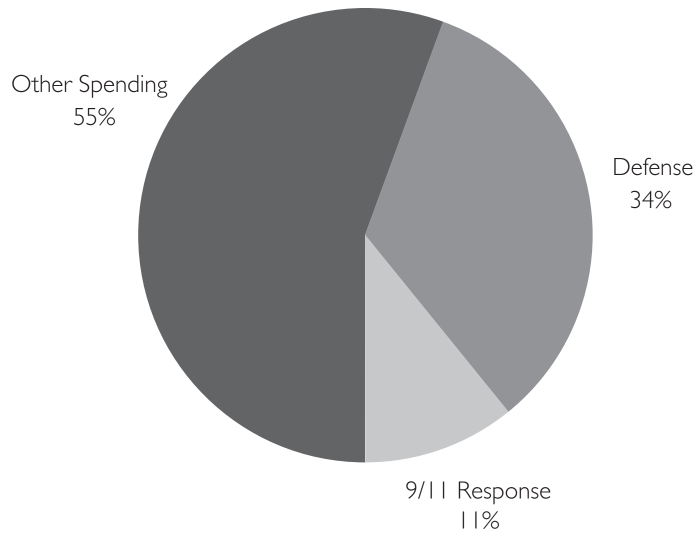
Trade Barriers. U.S. citizens currently pay higher prices for SUVs, textiles, lumber, sugar, peanuts, orange juice, and many other products than they would if there were no trade barriers in place[12] As if that were not enough, U.S. consumers and some producers suffered two blows to their pockets subsequent to the start of the Bush Administration: First, in March 2002, President

6. *Ibid*.
7. The top U.S. corporate tax rate is 35 percent.
8. Brian M. Riedl, "$20,000 per Household: The Highest Level of Federal Spending Since World War II," Heritage Foundation *Backgrounder* No. 1710, December 3, 2003, p. 1, at *www.heritage.org/Research/Budget/BG1710.cfm*.
9. *Ibid*., p. 2.
10. *Ibid*., p. 7.
11. *Ibid*., p. 4.

Bush raised steel tariffs to protect a few steel producers at the expense of all American consumers of steel and producers of steel-made products. Second, in May 2002, President Bush signed an agriculture bill that dramatically expanded farm subsidies, which essentially subsidize wealthy U.S. farms at the expense of millions of consumers.[13] In addition, the U.S. government continues to use China as the scapegoat for job losses in manufacturing and threatens to meddle with tariffs on Chinese products. The most recent proposal would impose nine different tariff rates on Chinese furniture.[14]

Chart 2 B 1781

Defense and 9/11 Account for Less Than Half of All Spending Increases Since 2001



Source: Heritage Foundation calculations based on data provided by the Office of Management and Budget and the Congressional Budget Office.

To its credit, the Bush Administration has engaged in an aggressive expansion of free trade with more than 10 nations, and President Bush lifted the steel tariffs in late 2003. These are steps in the right direction, but the Administration needs to express its support for freer markets more forcefully and credibly by pushing for elimination of subsidies and tariff barriers at once so that America can increase its economic freedom and preserve the image of a pro-freedom government.

Resting on Its Laurels. Much in the same way that the hare lost the race to the turtle, the United States is not taking economic competition with other countries seriously. America is relying too much on its self-image as the free market "champion," but already nine foreign economies have friendlier business environments. It is past time for the United States to start taking this race seriously.

Better policy choices have made these nine economies more attractive than the U.S. economy. For example:

- **Trade Policy.** Hong Kong, Singapore, and Estonia are virtually duty free. Each country's weighted average tariff rate is lower than 0.5 percent, and there are almost no non-tariff barriers. In contrast, the United States has an average weighted tariff rate of 1.8 percent and numerous non-tariff barriers, including import quotas, antidumping provisions, countervailing duties, and licensing requirements on a number of goods.[15]

---

12. Ana Isabel Eiras, "Why America Needs to Support Free Trade," Heritage Foundation *Backgrounder* No. 1761, May 24, 2004, p. 4, at *www.heritage.org/Research/TradeandForeignAid/bg1761.cfm*.

13. See Brian M. Riedl, "How Farm Subsidies Became America's Largest Corporate Welfare Program," Heritage Foundation *Backgrounder* No. 1520, February 25, 2002, at *www.heritage.org/Research/Budget/BG1520.cfm*, and Brian M. Riedl, "Another Year at the Federal Trough: Farm Subsidies for the Rich, Famous, and Elected Jumped Again in 2002," Heritage Foundation *Backgrounder* No. 1763, May 24, 2004, at *www.heritage.org/Research/Budget/bg1763.cfm*.

14. "Chinese Furniture Faces U.S. Tariffs," *The Wall Street Journal*, June 17, 2004, p. A2.

- **Fiscal Burden.** Hong Kong, Singapore, Ireland, Estonia, and Switzerland have better tax regimes. (See Table 2.)
- **Capital Flows and Foreign Investment.** Hong Kong, Singapore, New Zealand, Luxembourg, and Ireland have fewer restrictions on foreign investment and on the free movement of capital.
- **Regulations.** Hong Kong, Singapore, and Denmark have fewer regulations on establishing a new business—including labor laws, environmental and zoning regulations, and bureaucratic steps required to start a business.
- **Informal Market.** Singapore, New Zealand, Luxembourg, the United Kingdom, Denmark, and Switzerland have a smaller informal market.

Table 2 B 1781

Tax Burdens

	Hong Kong	Singapore	Ireland	Estonia	Switzerland	United States
Top Income Tax	15.5 %	22 %	42 %	26 %	11.5 %	35 %
Top Corporate Tax	17.5 %	22 %	12.5 %	0 %	30 %	35 %

Source: Marc A. Miles, Edwin J. Feulner, and Mary Anastasia O'Grady, *2004 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2004), at *www.heritage.org/research/features/index/downloads.html.*

The world does not stand still. The perception of the United States as the most attractive place to do business has changed now that other countries have surpassed the U.S. in economic freedom. That same perception will become more dated as the U.S. federal deficit swells; as Congress threatens more trade tariffs and passes legislation to support underfunded transfer programs like Medicare and Social Security; and as the President supports corporate welfare programs such as agricultural subsidies and the American Jobs Creation Bill (H.R. 4520)—a bill that would substitute new export subsidies for the old ones that the World Trade Organization (WTO) has found illegal.

America needs economic growth to maintain its high living standards, support its military power, and continue its influence around the world. To increase economic growth, America needs to "get serious" about the race by immediately sprinting toward economic freedom.

What the Bush Administration and Congress Should Do

The U.S. government should support economic freedom by all means at its disposal. Keeping America free of protectionism and special favors while reducing the fiscal burden of government will foster economic growth. To that end, both Congress and the Bush Administration should work together to:

- **Cut expenditures to balance the federal budget.** The federal government can balance its budget in two ways: cutting expenditures or raising taxes. Raising taxes means people keep less of what they earn, reducing incentives to produce more, thus thwarting economic growth. Therefore, the U.S. government should reduce government expenditures to ease the fiscal burden of government. Riedl recommends a strategy to keep federal spending under control, which includes the following actions:
  1. Cutting federal spending immediately;
  2. Freezing discretionary spending (which has increased by almost 40 percent since 2001) in 2005;

15. Miles *et al.*, *2004 Index of Economic Freedom*.

3. Reforming entitlements, including Medicare and farm subsidies; and
4. Reforming the budget process so that it limits spending growth and the ability for the government to pass on the burden of today's spending to future generations.[16]

- **Eliminate agricultural subsidies, antidumping measures, and other protectionist policies.** Subsidies and special protections benefit small economic interests or sectors at the expense of millions of American consumers and producers. They translate into higher prices, which disproportionally affect poor Americans. The Bush Administration should advance an agenda to eliminate agricultural subsidies at the WTO. It should take advantage of Europe's recent proposal to put the Doha round back on track by ending agricultural export subsidies, and it should encourage Japan to eliminate agricultural export subsidies as well.
- **Continue to support the expansion of free trade.** So far, the Bush Administration has advanced free trade agreements with Chile and Singapore and has completed negotiations with Central America, Australia, and Morocco. It should continue to negotiate free trade agreements with other countries around the world and Congress should approve these trade agreements.

Conclusion

America has been losing the "economic freedom" race for the last five years, according to the *Index of Economic Freedom.* That is worrisome because economic freedom is the foundation of U.S. economic growth and strength, and economic strength is the foundation of America's high living standards, military power, and overall power around the world.

The United States is falling behind, not just because it has tinkered with trade barriers and increased federal spending to the point of compromising the wealth of future generations, but also because it has been resting on its laurels enjoying its former reputation as the freest and most business-friendly economy in the world. That advantage is over. According to the *Index*, nine countries now score better on economic freedom than the United States.

Both the Bush Administration and Congress should support policies that advance economic freedom, so that the U.S. economy can grow strongly and thus provide resources to maintain America's high living standards, increase its military strength and security, and continue its role as a world leader. To that end, the Bush Administration and Congress should cut spending to balance the federal budget; eliminate agricultural subsidies, antidumping, and other protectionist policies; reform social welfare entitlement programs; and continue to support the expansion of free trade. More economic freedom at home will ensure that a healthy U.S. economy remains the solid basis of American prosperity and strength.

—Ana Isabel Eiras is Senior Policy Analyst for International Economics in the Center for International Trade and Economics at The Heritage Foundation.

16. For more details, see Brian M. Riedl, "How to Get Federal Spending Under Control," Heritage Foundation *Backgrounder* No. 1520, February 25, 2002, pp. 1–2, at *www.heritage.org/Research/Budget/bg1733.cfm.*