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Four Reforms to Regain U.S. Leadership in Economic Freedom

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If there is one thing about America that inspires the rest of the world, it is its level of economic freedom. Or at least it used to. According to the just-released *2005 Index of Economic Freedom*, published jointly by The Heritage Foundation and *The Wall Street Journal*, the United States is no longer among the world's 10 freest economies. In fact, the United States is becoming uncompetitive in economic freedom.

One reason for this decline is a combination of onerous taxes and increasing government expenditures, which worsens the fiscal burden on businesses. Another reason is that countries like Australia, Chile, and Iceland have leapfrogged past America by decisively and repeatedly cutting taxes, privatizing, and deregulating, thus creating friendlier business environments. The degree of economic freedom that the United States had 10 years ago, when it was ranked the fifth freest economy, is clearly no longer good enough.

This plunge in the economic freedom ranking is a warning bell. Economic freedom is the foundation of U.S. economic strength, and economic strength is the foundation of America's high standard of living, military power, and status as a world leader. To regain its leadership in this important area, America must cut taxes, cut government expenditures, eliminate non-tariff barriers to trade, and further deregulate some sectors of the economy. A freer U.S. economy will grow faster, and with faster growth, America will have the resources to raise its high living standard and to preserve its military power and status as a world leader.

Talking Points

- The United States is becoming uncompetitive in economic freedom. According to the just-released *2005 Index of Economic Freedom*, the United States is no longer among the world's 10 freest economies.
- In important areas of economic openness, the United States has simply failed to keep pace with a changing world.
- The perception of the United States as the most attractive place to do business has plummeted as Congress threatens more trade restrictions and tariffs and passes legislation to expand underfunded transfer programs like Medicare and Social Security, as tax rates remain among the highest in the world, as the U.S. remains one of the few countries to tax the overseas earnings of its corporations, and as some in the Administration support corporate welfare programs such as agricultural subsidies.
- A freer U.S. economy would grow faster and provide the resources needed to preserve America's high standard of living, military power, and status as a world leader.

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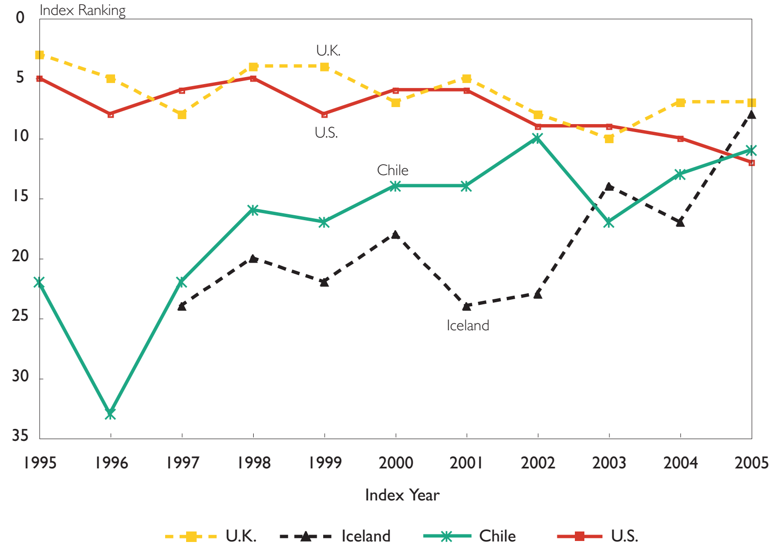
Falling Behind

Economic freedom measures the *opportunity for people* 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 children to school, and finding a job to counting on sound law enforcement and courts to protect their personal liberties and private property. The fewer the obstacles to these activities, the more people can participate in the economy by working, investing, saving, and consuming. The freer the economy, the more people can use their abilities to create wealth, putting money in the pockets of millions of families.

Chart 1 B 1815

Declining U.S. Ranking in the *Index of Economic Freedom* Since 1995, Compared to Chile, Iceland, and the United Kingdom



Note: Iceland was not graded in the 1995 Index and the 1996 Index.

Source: Marc A. Miles, Edwin J. Feulner, and Mary Anastasia O'Grady, *2005 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2005), at *www.heritage.org/index.*

Until recently, America epitomized the benefits of living in a free society. When the first *Index* was published in 1995, the United States was the fifth freest economy in the world, and it hovered at the top for the rest of the 1990s. The economy was booming during those six years. The compounded average growth rate from 1995 to 2000 was 4.1 percent,[1] driven largely by higher business productivity. Unemployment and inflation rates were at their lowest. The dollar was strong. Americans were consuming and investing fiercely.

However, in the four years since 2001, the U.S. ranking has fallen sharply from sixth place in 2001 to 12th place in 2005. Meanwhile countries such as Chile, Australia, and Iceland were opening their markets, improving their economic freedom. (See Chart 1.) During this time, U.S. government spending ballooned, and this continuous expansion of government expenditures has seriously hurt the U.S. ranking.[2]

The U.S. government has blamed the spending binge on the tragic events of September 11, 2001. However, according to Heritage Foundation analyst Brian Riedl, the majority of the government's spending spree since 2001 is unrelated to 9/11 or national defense.[3] For example, the increased expenditures have largely supported financially troubled programs like Social Security and Medicare; subsidized the rich, the famous, and the elected through farm subsidies to their expensive ranches;[4] and funded a myriad of special-interest projects such as "therapeutic horseback riding" and "a school mariachi music curriculum."[5] The money

1. World Bank Group, *World Development Indicators Online*, 2004, at *publications.worldbank.org/WDI* (January 4, 2005; subscription required).
2. For further reference, see Ana Isabel Eiras, "The United States Is No Longer the Champion of Economic Freedom," Heritage Foundation Backgrounder No. 1781, July 23, 2004, at *www.heritage.org/Research/TradeandForeignAid/bg1781.cfm.*
3. 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*. The 2001 rankings are based on spending increases that occurred in 1999, and the 2005 rankings are based on increases that occurred in 2003.

used to support those programs is money that U.S. workers and businesses have earned but cannot use for their own families or interests.

In other important areas of economic openness—taxes, non-tariff barriers, and regulations affecting local and foreign investment—the United States has simply failed to keep pace with a changing world. Recent reforms undertaken by countries now ranked in the top 10 in economic freedom illustrate the point.

- *First,* all of these countries strongly protect property rights.
- *Second,* Chile, Hong Kong,[6] Singapore, Estonia, Iceland, and Ireland have average top corporate tax rates that are half of the U.S. rate. Singapore, Estonia, Hong Kong, and Switzerland have much lower top personal income tax rates.
- *Third,* Singapore, Hong Kong, and Estonia are virtually duty-free with few non-tariff barriers. Chile has a weighted average tariff rate that is almost as low as the U.S. tariff rate, but with considerably fewer non-tariff barriers (e.g., quotas and antidumping laws).
- *Finally,* Hong Kong, Singapore, New Zealand, Luxembourg, Estonia, and Ireland have fewer restrictions on foreign investment and on the free movement of capital. In addition, 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.[7]

Should We Worry?

Should the United States, as a large economy, worry that it is losing its freedom "podium" to small economies like Chile, Iceland, New Zealand, or Estonia? Absolutely. One can never overestimate the damage caused by continuously poor policymaking.

For example, in the early 1900s, Argentina was the world's seventh wealthiest economy. Its wealth was driven largely by foreign direct investment from England and by strong enforcement of property rights. It took no more than 40 years of continuously poor policymaking, starting in the 1930s, to erode this wealth. Today, with its world leadership lost, Argentina is a poor country mired in crisis, with a currency that moneychangers around the world refuse to handle. Argentina did not become poor overnight. Its road to poverty began when it became blind to the eventual implications of poor policy.

The perception of the United States as the most attractive place to do business is changing as the downward trend in U.S. economic freedom continues. That perception plummets as spending swells the U.S. federal deficit, as Congress threatens more trade restrictions and tariffs and passes legislation to expand underfunded transfer programs like Medicare and Social Security, as tax rates remain among the highest in the world, as the U.S. remains one of the few countries to tax the overseas earnings of its corporations, and as some in the Administration support corporate welfare programs such as agricultural subsidies.

Four Reforms to Regain U.S. Leadership in Economic Freedom

It is time for America to rediscover the advantages that flow from increased economic freedom. Specifically, America needs sustained economic growth to maintain its high standard of living, military power, and leadership in the world, and to foster this economic growth, the United States needs to increase economic freedom by advancing four reforms.

4. 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*.
5. Brian M. Riedl and Keith Miller, "Another Pork-Laden Spending Omnibus Bill," Heritage Foundation *WebMemo* No. 613, November 22, 2004, at *www.heritage.org/Research/Budget/wm613.cfm*.
6. The *Index* treats the Hong Kong Special Administrative Region as a separate economy or "country."
7. Eiras, "The United States Is No Longer the Champion of Economic Freedom."

Reform #1: Cut tax rates.

One area in which the top 10 economically freest countries in the world distinguish themselves is low corporate tax rates. (See Table 1.) Estonia, which does not tax corporations, has the lowest rate.[8] Ireland, Chile, Hong Kong, and Iceland have a corporate tax rate that is only half that of the United States. Singapore and Luxembourg tax 13 percentage points less than the U.S., and Australia, Denmark, the United Kingdom, and New Zealand have slightly lower corporate tax rates than the United States.

The U.S. must find a way to slash its corporate tax significantly in order to be more competitive, providing businesses with better opportunities for increased production.

Table 1 B 1815

Top Corporate Tax Rates in the Economies Ranked Above the United States

Country	Top Corporate Tax Rate
Estonia	0.0%
Ireland	12.5%
Chile	17.0%
Hong Kong	17.5%
Iceland	18.0%
Singapore	22.0%
Luxembourg	22.9%
Australia	30.0%
Denmark	30.0%
United Kingdom	30.0%
New Zealand	33.0%
United States	35.0%

Source: Marc A. Miles, Edwin J. Feulner, and Mary Anastasia O'Grady, *2005 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2005), at *www.heritage.org/index.*

Reform #2: Cut government expenditures.

Rising government expenditures are imposing a burden on American families and future generations that will be hard to remove. According to David Walker, Comptroller General of the United States, the official debt of the United States government today is $7 trillion.[9] If the "promises" that the U.S. government has made to retirees and users of government health care services are added, "the real debt is $42 trillion," which amounts to "18 times the current federal budget, or three-and-one-half [times] the size of the current Gross Domestic Product."[10] In per capita terms, this obligation represents "over $140,000 for every person in America."[11]

Just to pay this debt, the U.S. economy would have to grow an average of 3 percent annually for the next 45 years, or 6 percent annually for the next 23 years, and incur no further obligations. These growth targets illustrate the extent to which current government actions have already affected the future of children born this year, who most likely will have to endure higher tax rates, higher interest rates, a much more difficult business environment, and a lower standard of living. For the government to leave them with such an inherited burden is just as irresponsible as it would be for their own parents to leave them with a long list of bills to pay.

In one of the 2004 presidential debates, President George W. Bush said that he would spend whatever it takes to make sure that America is safe. The American people expect nothing less of their President. However, Americans also expect both Congress and the Bush Administration to use taxpayers' money wisely so that financing the war on terrorism does not unnecessarily burden future generations.

8. Resident companies and permanent establishments of non-resident companies registered with the Estonian authorities are not subject to tax on their income.
9. Robert E. Moffit, Ph.D., "Can Congress Contain Explosive Medicare Costs?" Heritage Foundation *WebMemo* No. 523, June 18, 2004, at *www.heritage.org/Research/HealthCare/wm523.cfm.*
10. *Ibid.*
11. *Ibid.*

To reduce the unfunded debt burden on American families, the Administration should immediately advance proposals to reform Social Security, Medicare, and Medicaid. Also important, the Administration should stop supporting corporate welfare programs like the farm subsidies for the elite and wasteful pork-barrel projects like therapeutic horseback riding and mariachi music curricula. By cutting wasteful programs, the Administration would avoid burdening future generations.

Reform #3: Support free trade, especially at home.

The Bush Administration has decisively advanced free trade agreements with other countries. So far, the Administration has signed 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.

The U.S. record is dubious, though, when it comes to removing domestic barriers to trade, such as protectionist tariffs and antidumping laws. One of the worst cases is the stubborn protectionism of U.S. sugar growers. At the current level of protection, sugar sells in U.S. supermarkets at three times the world market price. Despite its size, however—the sugar industry supports only 61,000 direct jobs—its lobbying efforts are so strong that, according to Mary Anastasia O'Grady, editor of the "Americas" column at *The Wall Street Journal*, the sugar lobby is about to succeed in excluding the Dominican Republic from the Central America Free Trade Agreement (CAFTA) because, under CAFTA, the Dominican Republic would "win a market access quota equal to 1.7% of US production, after 15 years."[12] Excluding opportunities presented by trade with the Dominican Republic is a high price for average Americans to pay for such a tiny threat to the tiny sugar industry. Moreover, U.S. protectionism is just as bad in other industries, such as orange juice, peanuts, and dairy products.

Even worse are the U.S. antidumping laws. In principle, these laws give U.S. producers the right to request protectionist tariffs when a foreign producer sells his products in the United States at a lower price than it sells for in its own country. In practice, they create incentives for industries to seek ridiculous protections at the expense of taxpayers.

It all starts with the government's requirement that 25 percent of the industry making the product must support such a claim. To assess the level of support, the Department of Commerce surveys the industry with a form that producers must complete. Here the Byrd Amendment—in its effects, the most distorting antidumping law—comes into play. Under the amendment, once the antidumping duty is approved, the producers that support a dumping case are eligible to receive a portion of the duties collected.[13] This obviously creates a strong incentive to support a petition, and approval of every antidumping investigation is virtually guaranteed. A flawed methodology for identifying instances of dumping and the accompanying protection margins—a methodology that is usually biased against foreign producers—further compounds the problem.[14]

The damage does not stop there, though. With antidumping laws, producers have a mechanism for requesting protectionist tariffs where no tariff actually exists. In other words, no matter how many free trade agreements the U.S. makes or how many tariffs Congress tears down unilaterally, as long as the antidumping laws exist, U.S. producers will have an avenue they can use to pursue protectionism. Since success breeds imitation, many countries around the world now use antidumping laws as well. The U.S. government must repeal its antidumping laws, not just to preserve the interests of millions of U.S. consumers, but also to advance *effectively* free trade throughout the world.

12. Mary Anastasia O'Grady, "Sugar Daddy Decadence," *The Wall Street Journal*, November 19, 2004, p. A17.
13. Brink Lindsey and Daniel Ikenson, "Antidumping 101: The Devilish Details of 'Unfair Trade' Law," Cato Institute, Center for Trade Policy Studies *Trade Policy Analysis* No. 20, November 26, 2002, at *www.freetrade.org/pubs/pas/tpa-020es.html* (January 3, 2005).
14. *Ibid.*

Reform #4: Deregulate.

America's business environment is still perceived as one of the world's most business-friendly. Yet the flow of new regulations continues unabated, and the U.S. must address this problem in order to ease the regulatory burden on businesses. For example, foreigners should be allowed to invest in certain sectors that are currently off limits, such as nuclear energy, maritime and air shipping, broadcasting, and communications. In addition, many regulations (e.g., some health and product safety standards, and food and drug labeling requirements), although well-intentioned, can be particularly burdensome to small and medium-size businesses and should be removed.

Conclusion

America has fallen behind 11 countries in the economic freedom rankings in the *2005 Index of Economic Freedom* because it has failed to advance reform at home while other countries have continued to cut tax rates, lower trade barriers, and deregulate. This decline is serious because economic freedom is the foundation of U.S. economic strength, and economic strength is the foundation of America's high standard of living, military power, and status as a world leader.

To encourage greater economic growth, the United States must cut taxes, cut government expenditures, eliminate non-tariff barriers to trade, and further deregulate the economy. With greater freedom, America will grow faster, continue to inspire other nations, and leave a more promising future for future generations.

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