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The Fiscal Burden of Government Is Undercutting U.S. Competitiveness

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A competitive economy is at the heart of a country's prosperity. Only by producing products or services at or below world prices can countries create wealth. The freedom to access a variety of capital instruments, to hire and fire labor, and to keep the profits of efforts and innovation enhances the economy's potential for growth and wealth creation.

For many decades, the United States has exemplified this truth, and millions of American families have benefited from America's economic freedom. However, this may change soon. The growing fiscal burden of America's government could hold back the U.S. economy's future by undercutting U.S. competitiveness.

According to the *2006 Index of Economic Freedom*, just published by The Heritage Foundation and the *Wall Street Journal*, America's economic freedom ranking has trended down since the *Index*'s inception in 1995. The 161-country survey shows that, even though U.S. economic freedom has improved in absolute terms over the past 12 years, the U.S. has not kept pace with other countries. The degree of improvement has simply not been enough for America to remain one of the top freest economies in the world. Other countries, including Ireland, Estonia, Denmark, and Iceland, have leapfrogged over the United States and now offer greater economic opportunity.

America is still a great place to do business, but a closer examination of the reasons for the slip in its economic freedom ranking shows that America's personal and corporate tax rates are increasingly uncompetitive. For example, many countries throughout

Talking Points

- According to the just-published *2006 Index of Economic Freedom*, America's freedom ranking has trended down since 1995.
- When ranked solely by the fiscal burden of government, the U.S. fell from 50th in 1997 to 101st in the 2006 *Index*—seven places behind Denmark, 18 places behind Sweden, and 45 places behind Germany.
- America's personal and corporate tax rates are increasingly uncompetitive when compared with those of other countries.
- If U.S. tax rates do not keep pace with reforms elsewhere, U.S. economic growth will be compromised and wealth creation will decline, undermining the government's ability to pay its bills, including its obligations under the Social Security and Medicare programs.

This paper, in its entirety, can be found at:
www.heritage.org/research/tradeandforeignaid/bg1906.cfm

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Europe have slashed their rates, while the U.S. has done little. If U.S. tax rates do not keep pace with reforms elsewhere, economic growth will be compromised and wealth creation will decline, undermining the government's ability to pay its bills, including its obligations under the Social Security and Medicare programs.[1]

Both the Bush Administration and Congress should support policies that advance economic freedom so that the U.S. economy can continue to grow strongly and provide the resources to maintain America's high standard of living and role as a world leader. To that end, the Bush Administration and Congress should cut spending to balance the federal budget, lower corporate and personal income taxes, and continue to support the expansion of economic freedom. More economic freedom at home will ensure that a healthy U.S. economy remains the solid basis of American prosperity and strength.

Lose Economic Freedom, Lose Wealth Creation

Economic freedom is a measure of how unconstrained ordinary people are in their ability 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 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 country's wealth.

The *Index of Economic Freedom* provides a framework for measuring these constraints by identifying the most important components of economic freedom and determining how each country measures up, factor by factor. The *Index* assesses economic freedom in 10 different areas of the economy:

- Trade policy (tariffs and non-tariff barriers);
- Fiscal burden (taxes and government expenditures);
- Government intervention in the economy (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.[2]

Each country is scored on each of the 10 areas on a scale from 1 to 5, with 1 being the freest and 5 being the most 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 that country. The overall ranking of the country's score in the *Index* indicates how the business environment in that country compares to the rest of the world.[3]

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1. If not reformed soon, entitlement programs threaten to overwhelm the federal budget. See Brian M. Riedl, "Entitlement-Driven Long-Term Budget Substantially Worse Than Previously Projected," Heritage Foundation *Backgrounder* No. 1897, November 30, 2005, at *www.heritage.org/Research/Budget/bg1897.cfm*.
2. 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*," Chapter 5 in Marc A. Miles, Kim R. Holmes, and Mary Anastasia O'Grady, *2006 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2006), p. 55, at *www.heritage.org/index*.
3. The Heritage Foundation, "Past Scores," from *Index of Economic Freedom*, eds. 1996–2006, at *www.heritage.org/research/features/index/downloads/PastScores.xls*.

A "free economy" has 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 individuals have fewer opportunities to produce wealth because working and doing business become more 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.

The United States is a free (and rich) economy. However, it has suffered a relative loss of economic freedom in the past 12 years. Over that period, the U.S. has dropped from the world's fourth freest economy to its ninth freest.[4] Today, in eight countries, the opportunities for generating wealth are more abundant than in the United States.

America has lost its relative economic freedom for several reasons. The most important is the burden created by government fiscal policies. The *Index* measures the fiscal burden of government by the year-to-year change in government expenditures (as a percentage of gross domestic product) plus top marginal corporate and personal income tax rates. This is an area in which the United States is in free fall. When ranked solely by the fiscal burden of government, the United States fell from 50th in 1997 to 101st in the 2006 *Index*—seven places behind Denmark, 18 places behind Sweden, and 45 places behind Germany, which is even more remarkable given the high personal income tax rates in these countries. By contrast, Hong Kong is eighth in terms of fiscal burden, the Slovak Republic is 11th, and Ireland is 16th.[5]

This poor relative position in fiscal burden is caused primarily by high U.S. corporate and individual tax rates. The U.S. corporate rate ranks a dismal 117 out of the 161 countries surveyed in the 2006 *Index*.[6] The individual rate ranks 83rd. To make matters worse, rising government spending since 2000 has contributed to the relative worsening of the fiscal burden as well, and this situation promises to worsen as the massive commitments of entitlement programs come due, including the new prescription drug benefit passed by Congress and signed by President George W. Bush in 2003.

In contrast, in the years since the first *Index* was published in 1995, Germany has improved its overall fiscal burden score from 4.5 to 3.1 in 2006. (See Table 1.) Germany has achieved this level of improvement primarily by slashing its top corporate tax rate almost in half, from a top marginal rate of 50 percent in 1995 to 26.4 percent in the 2006 *Index*. The Slovak Republic has slashed both the top personal tax rate (42 percent) and the top corporate tax rate (40 percent) by more than 50 percent to a flat 19 percent in the 2005 *Index*. This meant not only that individuals and corporations had significantly more incentives to participate in the economy and pay taxes, but also that the flat tax added efficiency to the economy by reducing the time wasted completing forms and the fees associated with convoluted tax systems, such as the U.S. tax system.

Ireland made perhaps the most dramatic change, slashing the top corporate tax from 40 percent in 1995 to a mere 12.5 percent in 2004. The income tax rate declined by 6 percentage points over that period. Apart from tax cuts, the Slovak Republic and Ireland were both able to reduce government expenditures eight times since 1995, just as the United States did, while Germany reduced expenditures four times in the same period. (See Table 1.)

The tax cuts represent these governments' realization that, in a highly globalized world, the competition for capital and efficiency of labor is fierce. Other countries are catching up. For example, Russia trimmed its personal income tax from 30 percent in 1995 to a flat 13 percent in the 2002 *Index*, and the top corporate tax from 38 percent in 1995 to 24 percent in the 2003 *Index*. Romania announced early in 2005 that it cut both the top personal income and

4. *Ibid.*

5. *Ibid.*

6. *Ibid.*

Table 1 B 1906

Past Index Scores

Fiscal Burden Score

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Germany	4.5	4.6	4.5	4.6	4.6	4.4	4.4	3.5	3.8	3.8	3.5	3.1
Denmark		4.3	4.3	4.1	4.3	3.9	4.0	3.9	4.1	4.0	3.6	3.8
Sweden	4.3	4.3	3.5	3.4	3.5	3.5	3.3	3.8	3.8	4.0	3.9	3.6
United States	3.9	3.9	3.8	3.9	3.9	3.4	3.8	3.9	4.1	4.0	4.0	3.9
Slovakia	4.8	4.8	3.8	4.1	4.8	3.8	4.0	3.1	2.6	2.9	1.8	2.0
Romania	5.0	4.0	4.5	4.6	4.5	4.5	3.9	3.8	3.1	3.1	3.3	1.9
Russia	3.5	4.5	4.3	3.4	4.0	3.5	3.9	3.9	2.4	2.6	3.1	2.5
Ireland	4.5	4.4	4.4	4.1	3.8	3.1	3.0	2.8	2.8	2.4	2.5	2.3
Bulgaria	4.6	5.0	4.3	4.0	3.9	3.5	3.8	3.8	3.1	1.8	2.4	2.3

Individual Tax Rate (Percent)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Germany	53	53	53	53	53	53	51	51	48.5	48.5	47	44.3
Denmark		61	61	60	60	60	59	59	59	59	59	59
Sweden	50	50	55	56	56	56	56	60	60	60	60	60
United States	39.6	39.6	39.6	39.6	39.6	39.6	39.6	39.6	39.1	35	35	35
Slovakia	42	42	42	42	42	42	42	42	38	38	19	19
Romania	60	60	60	60	60	45	45	45	40	40	40	16
Russia	30	30	30	35	35	35	35	13	13	13	13	13
Ireland	48	48	48	48	48	46	46	44	42	42	42	42
Bulgaria	50	50	50	50	40	40	40	40	38	29	29	24

Corporate Tax Rate (Percent)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Germany	50	45	45	45	45	45	40	26.4	26.4	26.4	26.4	26.4
Denmark		34	34	34	34	34	32	30	30	30	30	28
Sweden	28	28	28	28	28	28	28	28	28	28	28	28
United States	35	35	35	35	35	35	35	35	35	35	35	35
Slovakia	40	40	40	40	40	40	29	29	25	25	19	19
Romania	38	38	38	38	38	38	38	25	25	25	25	16
Russia	38	38	35	35	35	35	35	35	24	24	24	24
Ireland	40	40	38	38	32	28	24	20	16	12.5	12.5	12.5
Bulgaria	40	40	40	36	30	30	30	25	20	19.5	19.5	15

Change in Government Expenditure

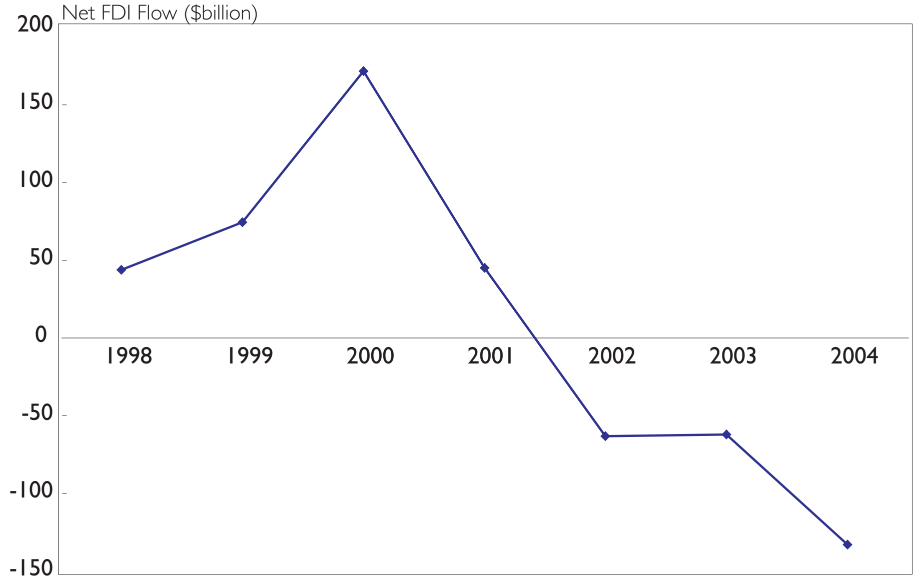
	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Germany	1.0	1.2	-0.3	0.4	0.9	-1.4	-1.6	0	2.4	0.3	0.9	-1.1
Denmark		2.7	-0.1	-1.3	-0.5	-3.4	-0.9	-1.3	0.5	0	1.1	-0.1
Sweden	5.2	5.5	-2.1	-3.3	-2.4	-2.9	-5.7	-0.5	-0.5	1.4	0.6	-1.5
United States	-0.5	-0.5	0.0	-0.5	-1.1	-0.7	-0.4	-0.1	1.1	1.0	0.2	-0.5
Slovakia	4.0	5.7	-5.4	-1.2	4.2	-3.4	1.9	-3.4	-5.7	-2.5	-3.2	-1.5
Romania	4.5	-5.7	-0.3	0.6	-0.4	0.9	-9.1	2.6	-1.7	-1.7	-0.8	0
Russia	-5.6	2.3	-0.3	0.6	-0.4	0.9	-9.1	2.6	-1.7	-1.7	-0.8	0
Ireland	0.4	-0.1	-0.8	-2.8	-1.9	-4.9	-3.7	-0.3	1.5	0.9	1.7	-0.1
Bulgaria	0.5	7.5	-2.4	-4.4	1.0	-2.9	-6.4	5.0	3.8	-3.5	-0.9	1.5

Source: The Heritage Foundation, "Past Scores," from *the Index of Economic Freedom*, eds. 1996–2006, at *www.heritage.org/research/features/index/downloads/PastScores.xls*.

corporate tax rates from 60 percent and 38 percent, respectively, to a flat 16 percent in the 2006 *Index*. Bulgaria's top income tax rate came down from 50 percent in 1995 to 24 percent in the 2006 *Index*, and the top corporate rate was lowered from 40 percent to 15 percent over the same period.

Chart 1 B 1906

United States: Net Flow of Foreign Direct Investment



Source: U.N. Conference on Trade and Development, FDI Database, at *stats.unctad.org/fdi/eng/ReportFolders/Rfview/Explorerp.asp?CS_referer=* (December 19, 2005, registration required).

As economic freedom in the U.S. falls relative to other countries, so do the relative opportunities to invest, work, and do business in the United States. This in turn affects the relative attractiveness of investing in America. 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 2, in 2004, the United States had the largest negative FDI flow relative to the eight freer (or equally free) economies in the world. Ireland, in contrast, had the largest positive FDI flow.

The U.S. economy is certainly still healthy. The U.S. Bureau of Economic Analysis recently announced a robust 4.3 percent growth in the U.S. economy in the third quarter of 2005,[7] and the Bureau of Labor Statistics announced the creation of 215,000 new non-farm jobs in November 2005 alone.[8] However, it is equally certain that other economies around the world are creating ways, such as slashing corporate taxes, to compete for business opportunities and profit from them. Clearly, the United States can no longer afford to rest on its laurels of being *the* great place to do business.

Spend Less and Cut Taxes

If U.S. tax rates do not keep pace with reforms elsewhere, the U.S. will become less competitive, economic growth will be compromised, and wealth creation will decline. As a result, it will become increasingly difficult to pay for the government's expenses, including Medicare and Social Security.

Cutting taxes should be the next big policy priority for Congress. For starters, American corporations should be taxed only for business conducted on American territory, as opposed to their entire global operations. At the moment, American corporations are taxed for income earned both at home and

7. U.S. Department of Commerce, Bureau of Economic Analysis, "Gross Domestic Product and Corporate Profits," November 30, 2005, at *www.bea.doc.gov/bea/newsrelarchive/2005/gdp305p.htm* (December 15, 2005).
8. U.S. Department of Labor, Bureau of Labor Statistics, "Economic News Releases: Employment Situation," December 2, 2005, at *www.bls.gov/news.release/empsit.nr0.htm* (December 15, 2005).

abroad. The only way for these companies to avoid taxation on foreign operations is to keep the foreign profits abroad. Global taxation is a huge disincentive for businesses to return capital to the U.S. and invest it in the U.S. economy. By remaining abroad, such capital instead goes to other nations, boosts other economies, and creates jobs outside the United States. Moreover, it yields little tax revenue.

Second, Congress needs to strengthen the economy by cutting and streamlining taxes on both corporate and personal income. The U.S. certainly enjoys a competitive edge in many areas, including offering a stable business environment and flexible labor laws. These areas make the United States a preferred place to do business. However, a growing number of countries are offering stable business environments, relaxing their labor conditions, and slashing corporate and income taxes. Therefore, the Administration and Congress must act to make the U.S. tax structure more competitive.

Opponents of tax cuts argue that cutting taxes will undermine the country's ability to sustain social programs like Medicare, Medicaid, and Social Security. However, these opponents fail to see that, to afford these programs, the U.S. economy must be healthy and experience strong economic growth. Economic growth (i.e., encouraging businesses and individuals to invest in the U.S. economy) requires offering investors a business environment better than those found elsewhere.

Congressional Budget Office projections already show that by mid-century the United States will barely be able to afford entitlement spending, even if all other spending is eliminated. According to Brian Riedl, a budget expert at The Heritage Foundation, the long-term picture of the entitlement-driven federal budget is "substantially worse" than previously projected:

> [A] realistic budget projection shows that combined nominal Medicare, Social Security, and Medicaid spending will double over the next decade. Adding the costs of the war on terrorism, Hurricane Katrina, and other congressional spending priorities pushes the total 2015 federal budget spending well past $4 trillion, and the budget deficit to $875 billion.[9]

Table 2 B 1906

Foreign Direct Investment Flows in 2004

Country	FDI
Ireland	$16,520
United Kingdom	$13,008
Singapore	$5,393
Estonia	$669
Denmark	-$359
Luxembourg	-$2,008
Iceland	-$2,286
Hong Kong	-$5,718
United States	-$133,435

Source: U.N. Conference on Trade and Development, FDI Database, at *stats.unctad.org/fdi/eng/ReportFolders/Rfview/Explorerp.asp?CS_referer=* (December 19, 2005, registration required).

The growth of entitlement programs will compromise the ability of the U.S. economy to grow. If the economy does not grow, eventually the U.S. will have insufficient income to tax in order to pay for such programs. Consequently, Congress will need either to slash these programs or to raise taxes sharply.

Both the Bush Administration and Congress must waste no time in cutting spending to balance the federal budget, lowering corporate and personal income taxes, and continuing to support the expansion of economic freedom. Leaving the U.S. economy shackled to high taxes and a convoluted tax system while other countries around the world increasingly are slashing their taxes is irresponsible since it is already compromising the U.S. economy's ability to grow healthily for the long term.

Conclusion

For many decades, America has exemplified the benefits of living in an economically free society. However, since 1995, when the *Index* first started

9. Riedl, "Entitlement-Driven Long-Term Budget Substantially Worse Than Previously Projected," p. 1.

assessing economic freedom, the United States has fallen behind little by little in the economic freedom race. That is worrisome because economic freedom is the foundation of U.S. economic growth and strength, as well as the foundation of America's high living standards and overall power around the world.

The United States is falling behind not only because it has increased federal spending to the point of compromising the wealth of future generations and maintains one of the highest top corporate tax rates and a high top individual tax rate, but also because the U.S. has been resting on its laurels, enjoying its former reputation as the world's freest and most business-friendly economy. That advantage is gone. According to the *Index*, eight 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 continue to grow strongly and provide the resources to maintain America's high living standards and to continue its role as a world leader. To that end, the Bush Administration and Congress should cut spending to balance the federal budget, lower corporate and personal income taxes, and continue to support the expansion of economic freedom. More economic freedom at home will ensure that a healthy U.S. economy remains the solid basis of American prosperity and strength.

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