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Competitiveness Means Less Government, Not More

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The Bush Administration has proposed the American Competitiveness Initiative, a $5.9 billion program ostensibly designed to "strengthen our nation's ability to compete in the global economy."[1] Key features include more money for federal research programs and new subsidies for mathematics and science teachers.

The American Competitiveness Initiative is the wrong solution in response to a flawed diagnosis. The United States is one of the world's most competitive economies, according to a wide variety of independent rankings. This lofty status is largely due to the fact that its government is comparatively small and markets are allowed to operate without crippling levels of intervention and regulation. Yet the Administration has arrived at the rather puzzling conclusion that expanding the size and burden of federal spending is a recipe for enhanced competitiveness.

If politicians increase the size and scope of government, America's economy will suffer and its relative competitiveness ranking will decline, assuming that other nations avoid similar mistakes. This is because government spending misallocates an economy's labor and capital, regardless of whether it is financed by taxes or by borrowing.[2] However, if policymakers reduce government spending, lower tax rates, break up the government school monopoly, and take other steps to liberalize the economy, America's competitive position will improve.

Talking Points

- The Bush Administration's American Competitiveness Initiative is misguided. The United States is one of the world's most competitive economies, ranking near the top of every index. That lofty ranking is largely due to smaller government, yet the Administration has arrived at the rather puzzling conclusion that expanding the size and burden of federal spending is a recipe for enhanced competitiveness.
- America may do well in overall rankings, but the United States has fallen behind in several areas. For instance, the U.S. corporate tax rate is very high by global standards. Reducing it would improve U.S. competitiveness and boost economic performance.
- The White House is correct to link competitiveness and education, but the assumption that more tax dollars will boost educational performance is dubious. America spends more per pupil than almost any other nation, yet educational outcomes are mediocre at best. Educational choice is a much better way to boost performance.

This paper, in its entirety, can be found at:
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Competitiveness and Government Policy

The United States is a rich nation, with broadly shared wealth and prosperity. Property rights, the rule of law, stable money, and a modest level of government combine to create an environment that is conducive to work, saving, investment, risk-taking, and entrepreneurship. Ideally, government policy should facilitate these types of productive behavior, thereby enabling higher living standards.

Competitiveness is the result of many factors, including trade policy, health care policy, fiscal policy, labor policy, regulatory policy, legal policy, and monetary policy.[3] This short paper will not attempt a comprehensive analysis, but instead will present data on America's competitive position, highlight an area—corporate taxation—where policymakers can improve competitiveness, and then explain why the American Competitiveness Initiative's emphasis on more federal education spending is misguided.

A key finding is that America does well in overall rankings, but certain reforms could improve competitiveness. For instance, America's corporate tax rate is very high by global standards, and reducing it would improve U.S. competitiveness and boost economic performance. America is also one of the few nations that double-taxes corporate income earned in other nations, thus exacerbating the damage caused by high marginal tax rates.

Another conclusion is that the White House is correct to link competitiveness and education, but the assumption that more tax dollars will boost educational performance is dubious, particularly considering the federal government's poor track record. Instead of focusing on the amount of money expended, policymakers should turn their attention to how the money is spent. America spends more per pupil than almost any other nation, yet educational outcomes are mediocre at best. Educational choice is a much better way to boost performance, though state and local governments rather than politicians in Washington should be the ones to liberalize the system.

Globalization has made reducing the burden of government critically important. Jobs and capital are now much more likely to migrate across national borders, and nations with lower taxes and less government are the ones reaping the benefits. This means that the rewards for good policy are greater than ever before, but the penalties for bad policy are equally large.

America's Competitive Ranking

America is one of the world's richest and freest economies. To some extent, this lofty position is due to other nations' mistakes. Few nations have the right institutions, such as rule of law, stable money, and property rights. Even fewer have the right policies, such as low taxes, open markets, and modest levels of government.

A number of international rankings measure or reflect competitiveness. The United States scores among the top 10 in all nine of these rankings. Indeed, America is the only nation that is in the top 10 of every ranking. These rankings are not the ultimate arbiter of global competitiveness, but they surely indicate a country's relative position.

A review of the rankings shows a clear pattern. The nations that appear most frequently have low levels of taxes, spending, and regulation. The United States is on top (9 of 9), but the other nations that show up most frequently—Singapore (7), Australia (7), Switzerland (6), Denmark (6), Hong Kong (5), Ireland (5) and the United Kingdom (5)—are generally considered among the world's most market-oriented jurisdictions. (See Table 1.) To maintain its competitive position, especially as other nations liberalize,

1. Press release, "State of the Union: American Competitiveness Initiative," The White House, January 31, 2006, at *www.whitehouse.gov/news/releases/2006/01/20060131-5.html* (April 6, 2006).

2. For more information, see Daniel J. Mitchell, Ph.D., "The Impact of Government Spending on Economic Growth," Heritage Foundation *Backgrounder* No. 1831, March 15, 2005, at *www.heritage.org/Research/Budget/bg1831.cfm*.

3. For more information, see 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), at *www.heritage.org/index*.

Table 1 B 1929

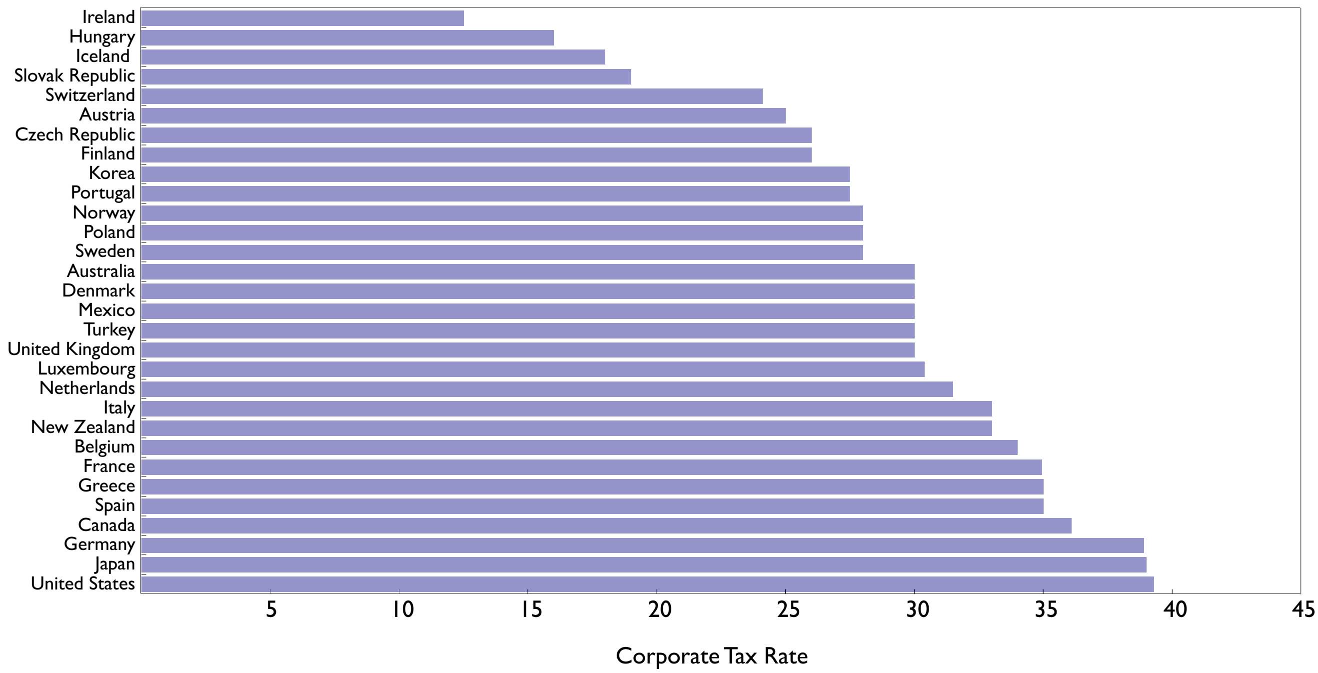
Country Competitiveness Rankings

Rank	World Bank Ease of Doing Business Index	Heritage Foundation Index of Economic Freedom	Fraser World Economic Freedom	World Economic Forum Index	IMD World Competitiveness Yearbook	KOF Index of Globalization	World Bank GNI per Capita	Forbes Capital Hospitality Index	A.T. Kearny/Foreign Policy Globalization Index
1	New Zealand	Hong Kong	Hong Kong	Finland	**United States**	**United States**	Luxembourg	Denmark	Singapore
2	Singapore	Singapore	Singapore	**United States**	Hong Kong	Sweden	Bermuda	Finland	Ireland
3	**United States**	Ireland	**United States**	Sweden	Singapore	Canada	**United States**	Iceland	Switzerland
4	Canada	Luxembourg	New Zealand	Denmark	Iceland	United Kingdom	Norway	**United States**	**United States**
5	Norway	Iceland	Switzerland	Taiwan	Canada	Luxembourg	Switzerland	United Kingdom	Netherlands
6	Australia	United Kingdom	United Kingdom	Singapore	Finland	Austria	Liechtenstein	Singapore	Canada
7	Hong Kong	Estonia	Canada	Iceland	Denmark	France	Ireland	Australia	Denmark
8	Denmark	Denmark	Ireland	Switzerland	Switzerland	Australia	Channel Islands	Estonia	Sweden
9	United Kingdom	**United States**	Australia	Norway	Australia	Switzerland	Iceland	Ireland	Austria
10	Japan	New Zealand, Australia	Luxembourg, Estonia	Australia	Luxembourg	Hong Kong	Austria	New Zealand	Finland

Source: World Bank, "Doing Business: Economy Rankings," 2006, at *www.doingbusiness.org/EconomyRankings/Default.aspx* (April 4, 2006); 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), at *www.heritage.org/index*; James Gwartney, Robert Lawson, and Erik Gartzke, *Economic Freedom of the World: 2005 Annual Report* (Vancouver: The Fraser Institute, 2005); World Economic Forum, "Growth Competitiveness Index Rankings 2005 and 2004 Comparisons," updated September 27, 2005, at *www.weforum.org/site/homepublic.nsf/Content/Growth+Competitiveness+Index+rankings+2005+and+ 2004+comparisons* (April 4, 2006); International Institute for Management Development, "The World Competitiveness Scoreboard 2005," at *www01.imd.ch/documents/wcc/content/overallgraph.pdf* (April 4, 2006); Axel Dreher, "2006 Index of Globalization," Swiss Institute for Business Cycle Research, at *www.kof.ethz.ch/deutsch/globalization/download/rankings_2006.pdf* (April 4, 2006); World Bank, "GNI per Capita 2004, Atlas Method and PPP," World Development Indicators Database, July 15, 2005, at *siteresources.worldbank.org/DATASTATISTICS/Resources/GNIPC.pdf* (April 4, 2006); Forbes, "Capital Hospitality Index," February 6, 2006, at *www.forbes.com/lists/2006/6/Score_1.html* (April 4, 2006); and Foreign Policy and A.T. Kearney, "Measuring Globalization," Foreign Policy, No. 141 (May/June 2005), at *www.atkearney.com/shared_res/pdf/2005G-index.pdf* (April 4, 2006).

Chart 1 B 1929

America's Corporate Tax Rate Is Very Uncompetitive



Note: Data for Japan, Greece, and Poland were constructed using some 2004 data if 2005 data were not available.

Source: Chris Atkins and Scott Hodge, "The U.S. Corporate Income Tax System: Once a World Leader, Now a Millstone Around the Neck of American Business," Tax Foundation *Special Report* No. 136, November 2005, at *www.taxfoundation.org/files/f6c39320f8909945da06abb30f781a58.pdf* (April 6, 2006).

the United States should seek ways to encourage productive behavior by reducing the burden of government.

Fixing the Tax Code to Boost Competitiveness

Of the many government policies that influence national competitiveness, taxes are one of the most important. America's overall tax burden is low compared to Europe's. This is good news and helps to explain why the U.S. economy grows faster and creates more jobs than the German and French economies.

This does not mean that America has an advantage in all areas, however. For instance, the United States has one of the highest corporate income tax rates in the industrialized world. The federal government imposes a corporate income tax rate of 35 percent, and state corporate tax burdens increase the effective tax rate to 40 percent. According to the Tax Foundation, this is the highest corporate tax burden of any developed nation.[4]

America has fallen behind because many other nations—particularly in Europe—have dramatically lowered their corporate tax rates in the past 15 years. This vigorous tax competition has led to bet-

4. Chris Atkins and Scott Hodge, "The U.S. Corporate Income Tax System: Once a World Leader, Now a Millstone Around the Neck of American Business," Tax Foundation *Special Report* No. 136, November 2005, at *www.taxfoundation.org/files/f6c39320f8909945da06abb30f781a58.pdf* (April 6, 2006).

ter tax policy. Perhaps the most spectacular example is Ireland, which lowered its corporate rate from 50 percent to just 12.5 percent. It is no coincidence that Irish living standards and competitiveness skyrocketed following these reforms.

Table 2 B 1929

Worldwide Taxation Punishes U.S. Company Competing in Ireland

	Profit	Irish Tax	Additional Tax	Total Tax
U.S. company	$100	$12.50	$22.50 to IRS	$35.00
Local company	$100	$12.50	0	$12.50
Dutch company	$100	$12.50	0	$12.50

Source: Author's calculations.

As the Tax Foundation study illustrates, many other nations have likewise reduced corporate tax rates to help their companies compete in the global economy. Slovakia's tax rate on corporate income is 19 percent. Iceland has an 18 percent tax rate on business income, and Hungary imposes a 16 percent tax rate. Even welfare-state nations like France and Sweden have lower corporate tax rates than America.

Adding insult to injury, American-based companies are taxed on their worldwide income.[5] This policy is very anti-competitive, subjecting U.S. companies that compete in global markets to higher tax rates than those paid by companies based in other nations.

For example, an American-based company operating in Ireland is at a disadvantage because its profits are subject to the 35 percent federal U.S. corporate income tax in addition to Ireland's 12.5 percent corporate tax. The U.S. company generally can claim a credit for taxes paid to Ireland, so the overall tax rate on Irish-source income theoretically should not exceed 35 percent.

As Table 2 indicates, however, this still means that the U.S. firm pays nearly three times as much tax as an Irish company pays. It also means that the U.S. firm pays nearly three times as much tax as a Dutch firm competing in Ireland pays, since the Netherlands has a territorial tax system. Furthermore, these foreign tax credits are not always available because they can expire or be limited by other factors.

Making matters worse, the tax code contains a plethora of rules that impose heavy compliance costs on U.S.-based multinationals. For instance, tax rules for using foreign tax credits are so onerous that the effective tax rate on foreign-source income is even higher than the U.S. corporate rate. Companies are also forced to misallocate certain expenses to increase taxable income artificially.

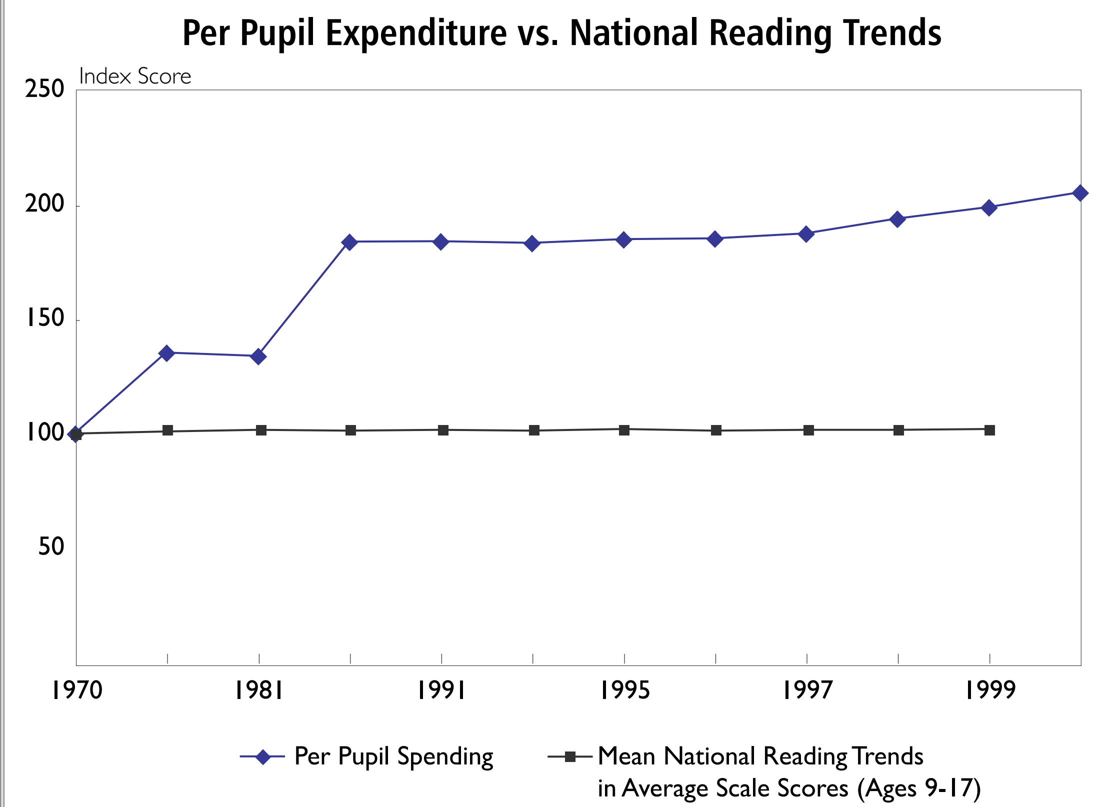
Even features designed to mitigate the anti-competitive nature of worldwide taxation—such as deferral—are subject to a multiplicity of restrictions.[6] Worldwide taxation means that U.S.-based companies are not allowed to compete on a level playing field. Most nations do not tax companies on their worldwide income. This means that companies based in those nations can take full advantage of the low corporate tax rates that now exist in so many countries.[7]

America's high corporate tax rate and worldwide tax system should be fixed to improve competitive-

5. Determining taxable foreign-source income is complicated. According to the Joint Committee on Taxation, the tax code has an "extensive set of rules governing the determination of the source, either U.S. or foreign, of items of income and the allocation and apportionment of items of expense against such categories of income." See Joint Committee on Taxation, U.S. Congress, *Description and Analysis of Present-Law Rules Relating to International Taxation*, June 28, 1999, at *www.house.gov/jct/x-40-99.htm* (April 6, 2006).

6. As the Joint Committee on Taxation explains, "A variety of complex anti-deferral regimes impose current U.S. tax on income earned by a U.S. person through a foreign corporation." See *ibid.*

Chart 2 B 1929



Sources: U.S. Department of Education, Institute of Education Sciences, National Center for Education Statistics, *National Assessment of Educational Progress*, selected years, 1971–2004, Long-Term Trend Summary Data Tables, at *nces.ed.gov/nationsreportcard/ltt/results2004/2004_sdts.asp* (April 7, 2006), and *Digest of Education Statistics, 2004*, Table 167, at *www.nces.ed.gov/programs/digest/d04/tables/dt04_167.asp* (April 7, 2006).

ness. The corporate tax rate should be reduced to 20 percent,[8] and worldwide taxation should be replaced by territorial taxation—the common-sense notion of taxing only income earned inside national borders.[9]

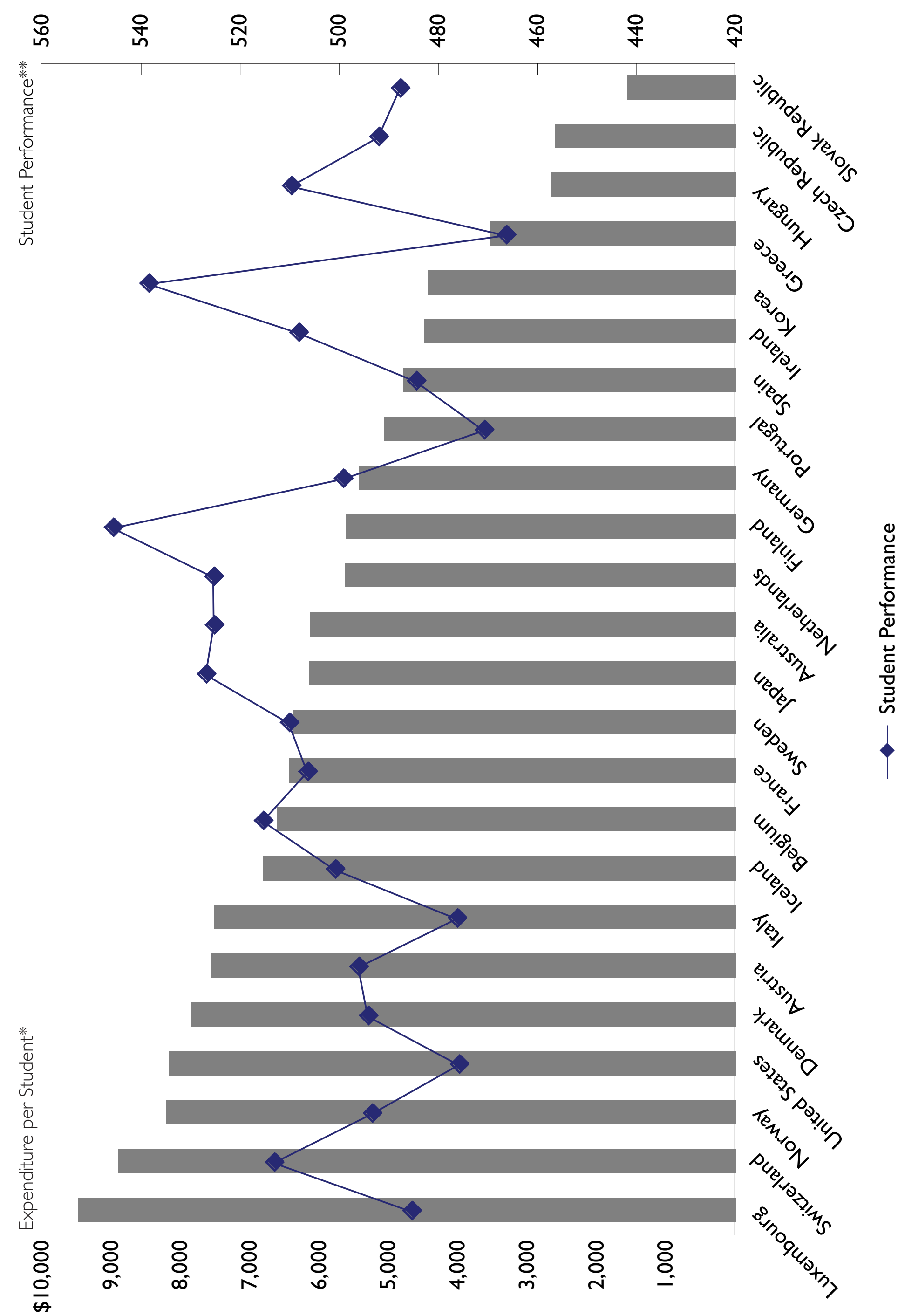
Education: Better Spending, Not More Spending

The President proposes to spend more money on research and education as part of his Competitiveness Initiative, but this approach is misguided. More

7. According to the Joint Committee on Taxation, "if a source [foreign] country provides low effective tax rates on manufacturing income, a taxpayer resident in a country with a territorial tax system will fully enjoy the benefits of the lower source-country rate, while a taxpayer resident in a country with a worldwide tax system generally will not." See Joint Committee on Taxation, U.S. Congress, *The U.S. International Tax Rules: Background and Selected Issues Relating to the Competitiveness of U.S. Businesses Abroad*, July 14, 2003, at *www.house.gov/jct/x-68-03.pdf* (April 6, 2006).
8. Chris Edwards, "Corporate Tax Reform: Kerry, Bush, Congress Fall Short," Cato Institute *Tax and Budget Bulletin* No. 21, September 2004, at *www.cato.org/pubs/tbb/tbb-0409-21.pdf* (April 6, 2006).
9. Daniel J. Mitchell, Ph.D., "Making American Companies More Competitive," Heritage Foundation *Backgrounder* No. 1691, September 25, 2003, at *www.heritage.org/Research/Taxes/BG1691.cfm*.

Chart 3 B 1929

Education: Expenditure vs. Performance



* The mean of primary and secondary spending.
** The mean of reading, scientific, and mathematical literacy scales.

Sources: Organisation for Economic Co-operation and Development, *Education at a Glance 2004: OECD Indicators*, 2004, at *www.oecd.org/edu/eag2004* (April 7, 2006), and *Learning for Tomorrow's World: First Results from PISA 2003*, 2004, at *www.pisa.oecd.org/dataoecd/1/60/34002216.pdf* (April 7, 2006).

spending has not proven to raise educational achievement. To improve competitiveness, America needs competition in its K–12 educational system. In other words, the problem is the structure of the education system, not the amount of money being spent.

Government-run schools have not provided good value for taxpayers. The federal government's involvement has been particularly ill-fated.[10] As Chart 2 illustrates, education spending in the United States has increased dramatically since 1970, yet educational output has remained flat.

The ambiguous relationship between government spending and educational performance is confirmed by global evidence. The international data in Chart 3 show no relationship between the amount of money spent and the quality of education delivered.

While America's K–12 educational system has a mediocre track record, America's universities are much more competitive—at least relatively speaking. *The Times* of London publishes the best-known international ranking, and American universities hold seven of the top 10 slots and 12 of the top 20 slots. (See Table 3.)

Table 3 B 1929

The World's Top 20 Universities

1.	Harvard University	U.S.
2.	Massachusetts Institute of Technology	U.S.
3.	Cambridge University	U.K.
4.	Oxford University	U.K.
5.	Stanford University	U.S.
6.	University of California, Berkeley	U.S.
7.	Yale University	U.S.
8.	California Institute of Technology	U.S.
9.	Princeton University	U.S.
10.	Ecole Polytechnique	France
11.	Duke University	U.S.
11.	London School of Economics	U.K.
13.	Imperial College of London	U.K.
14.	Cornell University	U.S.
15.	Beijing University	China
16.	Tokyo University	Japan
17.	University of California, San Francisco	U.S.
17.	University of Chicago	U.S.
19.	Melbourne University	Australia
20.	Columbia University	U.S.

Source: "World University Rankings 2005," *The Times Higher*, at *www.thes.co.uk/statistics/international_comparisons/2005/top_unis.aspx?window_type=popup* (April 4, 2006).

Competition is one of the reasons that American universities are so well regarded, particularly when compared to K–12 education. Students are not required to attend a college based on where they live. Universities therefore have to compete by offering a better product. Even if government subsidies and programs distort the pricing of higher education,[11] the presence of choice results in a better product.

Fortunately, there are growing signs that policymakers understand this lesson. Places like Milwaukee, Cleveland, and the state of Florida have implemented successful school choice programs, boosting students' educational performance and triggering improvements in the public schools that feel the competition of choice.[12] This should

10. For more information, see David Salisbury, "Chapter 28: Department of Education," in Edward H. Crane and David Boaz, eds., *Cato Handbook for Congress: Policy Recommendations for the 108th Congress* (Washington, D.C.: Cato Institute, 2003), pp. 108–128, at *www.cato.org/pubs/handbook/hb108/hb108-28.pdf* (April 6, 2006), and Neil McCluskey, "A Lesson in Waste: Where Does All the Federal Education Money Go?" Cato Institute *Policy Analysis* No. 518, July 7, 2004, at *www.cato.org/pubs/pas/pa518.pdf* (April 6, 2006).

11. Richard Vedder, "Colleges Have Little Incentive to Hold Down Costs," *Los Angeles Times*, July 18, 2004, reposted at *www.aei.org/publications/pubID.20941,filter.all/pub_detail.asp* (April 6, 2006).

12. For more information, see Krista Kafer, "Choices in Education: 2005 Progress Report," Heritage Foundation *Backgrounder* No. 1848, April 25, 2005, at *www.heritage.org/Research/Education/bg1848.cfm*.

become the norm rather than the exception, particularly as the United States becomes a more knowledge-based economy. State and local officials should build on these successes by expanding competition, and the President could use his "bully pulpit" to promote these much-needed reforms.

Conclusion

America's economy is competitive largely because the burden of government is small relative to the burden of government in other countries, but this does not mean that policymakers should rest on their laurels. In a competitive global economy, jobs and capital will migrate to the jurisdictions that are lowering tax rates and improving the environment for productive economic activity.

This requires the right diagnosis. Contrary to what some politicians argue, America's competitive position is not threatened because the federal government is not spending enough. Instead, the problem is that government is too big. Excessive government necessarily causes the misallocation of labor and capital, and the high tax rates needed to finance that level of government will discourage work, saving, and investment.

Policymakers should concentrate on reducing the burden of government. The corporate tax rate would be a good place to start. The U.S. arguably has the worst system in the industrialized world, both because of the high tax rate and because of the pernicious policy of worldwide taxation. Meanwhile, rather than increase federal interference in education, policymakers should concentrate on decentralizing education and implementing school choice.

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