IMPACT ANALYSIS

Opportunities and Risks Impacting International Business

A Publication Serving the Mississippi Business Community *September-October 2005*

Dear Friends:

Is the United States falling behind other countries in terms of economic freedom? Ana Isabel Eiras says yes, and offers four reforms to help get the U.S. back on track (p1-3).

Do U.S. manufacturers who establish facilities abroad typically seek cheap labor? John Manzella says no, and lays out a compelling argument (p4).

And finally, how does a country reinvent itself, and in doing so, become a model for developing countries to follow? Learn how Ireland transformed itself into one of the world's most attractive investment destinations.

I hope you find this issue informative, and as always, we welcome your comments.

Sincerely,

Barbara Travis
Executive Director
Mississippi World Trade Center

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

By Ana Isabel Eiras

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 *2005 Index of Economic Freedom*, published jointly by The Heritage Foundation and *The Wall Street Journal*, the U.S. is no longer among the world's 10 freest economies. In fact, the U.S. is becoming uncompetitive in economic freedom.

Reasons for Decline

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 U.S. had 10 years ago, when it was ranked the fifth freest economy, is clearly no longer good enough.

A Warning Is in Order

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 and 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.

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 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.

Until recently, America epitomized the benefits of living in a free society. 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 other countries were opening their markets and improving their economic freedom. During this time, U.S. government spending ballooned, and this continuous expansion of government expenditures has seriously hurt the U.S. ranking.

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.

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

In other important areas of economic openness—taxes, non-tariff barriers and regulations affecting local and foreign investment—the U.S. has simply failed to keep pace with a changing world.

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 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 U.S. 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, Congress threatens more trade restrictions and tariffs and passes legislation to expand underfunded transfer programs, tax rates remain among the highest in the world, the U.S. remains one of the few countries to tax the overseas earnings of its corporations, and 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.

Reform #1: Cut Tax Rates

One area in which the top 10 economically freest countries in the world distinguish themselves is through low corporate tax rates. The U.S. must find a way to slash its corporate tax significantly in order to be more competitive and provide businesses with better opportunities for increased production.

Reform #2: Cut 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. 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." In per capita terms, this obligation represents "over $140,000 for every person in America."

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.

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.

Reform #3: Support Free Trade, Especially at Home.

The Bush Administration has decisively advanced free trade agreements with other countries. It should continue to do so with others.

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. 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 products in the U.S. at a lower price than in the producer's home country. In practice, this creates 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 effect 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. 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 compound the problem.

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 antidump-

ing 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.

Reform #4: Deregulate

The flow of new regulations continues unabated. This problem must be addressed in order to ease the regulatory burden on businesses. For example, foreigners should be allowed to invest in certain sectors that are off limits. In addition, many regulations (e.g., some health and product safety standards, food and drug labeling requirements, or corporate-governance regulations like Sarbanes-Oxley), although well-intentioned, can be particularly burdensome to small and medium-size businesses and should be removed.■

> To encourage greater economic growth, the U.S. must cut taxes, and 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.

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

Do U.S. Manufacturers Who Establish Facilities Abroad Typically Seek Cheap Labor?

Excerpted from John Manzella's soon to be released book, *Grasping Globalization: Its Impact and Your Corporate Response*

Although U.S. manufacturers are anticipated to invest an increasing amount of capital in China over the next decade, overall, only a relatively small portion of U.S. FDI is invested in developing countries or countries with low-cost labor. Contrary to what many believe, in 2003 only 15 percent of U.S. manufacturing FDI was directed into developing countries, including China, according to the Deloitte research report, *Growing the Global Corporation: Global Investment Trends of U.S. Manufacturers.* This number is up from 7 percent in 2002, but down from 22 percent in 2001, 25 percent in 2000, and 32 percent in 1999.

"Despite what would appear to be major opportunities for FDI in emerging markets, such as China and India, most U.S. manufacturers are putting their investment bets on the developed markets... For example, U.S. manufacturing FDI into India fell to just over $50 million in 2003, down 80 percent from nearly $250 million in 1999. Investments by U.S. manufacturers into China—a hotbed of global manufacturing expansion—reached $760 million in 2003; down more than 52 percent from nearly $1.3 billion in 1999, although recovering slightly from a low of $575 million in 2002," the Deloitte report said.

The most important determinants of capital flows are political stability, education and productivity levels, communications and transportation infrastructure, the rule of law, proximity to market and the ability to repatriate profits. This is why developed countries, which pay the highest wages and have the strongest environmental laws, are the destinations for the vast majority of foreign direct investment. This also is why foreign companies operate in the United States—companies that employed 5.4 million Americans with a U.S. payroll of $307 billion in 2002.

Although exceptions exist, many anti-globalist organizations would have you believe that, as a whole, U.S. manufacturers investing abroad seek low-cost facilities that provide sweatshop-like working conditions. If this were correct, investment would be flowing to underdeveloped countries with the poorest labor standards and environmental records. In reality, as demonstrated above, the opposite is true. Although the intentions of these anti-globalist organizations are good, their logic is flawed.

American manufacturers who do invest in developing countries typically offer higher wages and better working conditions than local employers. This makes jobs at U.S. facilities highly prized and, over time, leads to improved environmental and worker protection at all levels.

American manufacturers who do invest in developing countries typically offer higher wages and better working conditions than local employers. This makes jobs at U.S. facilities highly prized and, over time, leads to improved environmental and worker protection at all levels. In fact, U.S. companies operating abroad act as agents for change. Through their operating standards, business practices, values and principles, U.S. companies often serve as role models, charting a path for other foreign and domestic companies to follow. This strategy, which is good for business, results in greater employee loyalty, less absenteeism, higher morale and increased productivity.

Procter & Gamble is a case in point. From 1991 through 2002, the company invested $85 million in a Czech Republic consumer products company that produces detergent and liquid cleaners. By applying P&G's worldwide environmental standards, the facility was able to reduce boiler emissions by 99 percent and solid waste by nearly 6,000 metric tons. In addition to environmental improvements, P&G introduced a competitive compensation program and unique employee benefits. In 2002, it was reported that P&G also donated $120,000 annually to the development of local education, health care, environmental protection, and social institutions. So impressed with these practices, Czech Republic former President Vaclav Havel recently said P&G "could serve as a model for other investors." ■

— For information about *Grasping Globalization: Its Impact and Your Corporate Response,* go to www.ManzellaTrade.com. The book is anticipated to be released in October 2005.

Ireland: Catching the Celtic Tiger by the Tail

By John Manzella

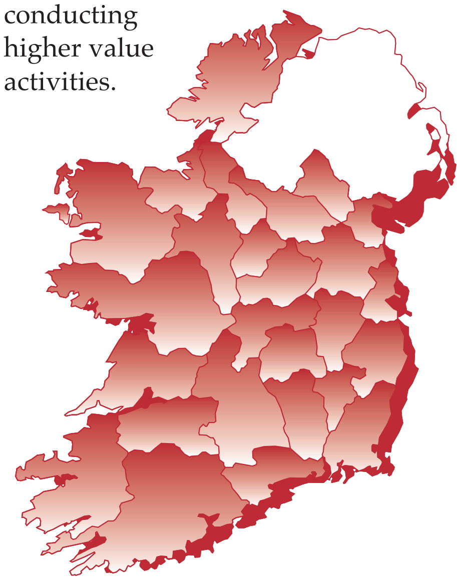
The image of Ireland as an agrarian society faded long ago. In recent years, the Republic of Ireland has focused on the next generation of industries: biotechnology, nanotechnology and digital media. In doing so, the country has achieved rapid growth and attracted impressive amounts of foreign direct investment (FDI). In fact, from 1995 through 2004, world cumulative FDI received by Ireland was slightly less than received by Mexico, but considerably more than received by Italy, Switzerland or Japan, according to the Organisation for Co-operation and Development.

Yahoo and Amazon are the latest internet giants to set up operations in Dublin, Ireland, joining other internet leaders already there, according to IDA Ireland. And a number of other future oriented industries continue to grow. For example, 13 out of the world's top 15 pharmaceutical companies currently have substantial operations in Ireland and employ more than 17,000 people at 82 production facilities, according to IDA Ireland.

Interestingly, Ireland reports exports of IT services two times larger than the U.S. This is a tremendous accomplishment especially since Ireland employed only 24,000 IT specialists in 2003, according to the *2005 World Trade Report* published by the WTO.

Strategies that Work

How has Ireland achieved all this success? The country has created an environment attractive to knowledge-based activities, especially information and communication technology, and biotechnology. This has involved a close working relationship with science and R&D institutions. In addition, FDI attraction strategies seek opportunities that create niches and distinguishable clusters. This has positioned Ireland as a center for innovation and emerging technology. And with the understanding that basic manufacturing of commodity products will continue to migrate to lower cost locations, Ireland seeks more advanced manufacturing that employs higher skilled workers conducting higher value activities.



The Young and Highly Educated

The availability of young, skilled labor is an important factor in choosing where to locate facilities. Ireland, where job creation has been strong and employment expanded by 3 percent in 2004, has the youngest workforce in Europe. This means a sufficient supply of manpower likely will be available well into the future.

Importantly, the Irish workforce is well educated and has one of the highest education participation rates in the world. But what they're studying really tells the tale. Ireland has the highest proportion of science and engineering graduates in the European Union (EU).

Irish universities and colleges also have a strong history of collaboration with industry, especially in emerging high technology sectors. In addition, the Irish work ethic is highly valued by employers. Surveys show that investors consider the quality and the "can do" flexible attitude of Irish workers to be among the country's greatest attributes.

Strong Growth and Many Incentives

This country of four million people has enjoyed economic growth rates among the highest in the world. Thus, Irish average gross domestic product (GDP) growth rates jumped from 3.2 percent in 1980-1990 to 6.9 percent in 1990-1999—more than doubling in just a decade. The island's real GDP growth rate is estimated to hover around 5.5 percent in 2005 and average 4.7 percent from 2007 through 2010.

With tariff-free access to the EU market of 448 million consumers, Ireland offers efficient distribution networks and world-class shared service centers that provide financial, general administrative and management functions. Very importantly, Ireland also offers one of the most attractive corporate tax rates in the world. At 12.5 percent, the rate is lower than that of the U.K., at 30 percent; France, 33.33 percent; Germany, 26.38 percent; and Italy, 33 percent.

As the island continues to develop and evolve, it is a prime candidate for U.S. trade and investment opportunities. ■

—John Manzella is president of Manzella Trade Communications, Inc.