Testimony before the House Committee on Energy and Commerce Subcommittee on Commerce, Trade, and Consumer Protection regarding the National Manufacturing Strategy Act

Kevin A. Hassett

Director of Economic Policy Studies

American Enterprise Institute

July 14, 2010

The views expressed in this testimony are those of the author alone and do not necessarily represent the views of the American Enterprise Institute.

Chairman Rush, Ranking Member Whitfield, and members of the subcommittee, it is an honor to appear before you to discuss the National Manufacturing Strategy Act.

In my view, the economic science supporting this Act is essentially nonexistent. Accordingly, passing it into law would be a policy error. Whether the policy error is major or minor would depend on whether the Strategy Task Force and Strategy Board are, like most such entities in Washington, irrelevant. If they are not, then the Act could significantly harm the business environment in the United States.

This testimony will discuss why I have reached this conclusion. I will begin by discussing historic trends in manufacturing in the United States. I will then discuss the economic forces, including current policy, that are driving these trends. Finally I will relate these forces to the Act, and indicate why it is misguided.

The Decline in Manufacturing

The decline of the U.S. manufacturing sector has been well documented. Figure 1 plots the share of manufacturing in total GDP for the U.S. from 1947 through 2009. As can be seen in the chart, manufacturing's share has dropped precipitously, from about 28 percent of GDP to about 11 percent of GDP.

Looking at the aggregate picture, this decline is not necessarily a cause for concern. Over the past few decades, our economy has transformed dramatically, and the importance of innovation and new ideas has increased sharply.

A recent study by the Federal Reserve indicates just how rapidly.[1] The study highlights that companies invest in tangible capital, the buildings and machines of heavy industry, and intangible capital, like the many patents that go into making an iPhone possible. The study concludes that investment in intangible capital is more important today in the aggregate than investment in tangible capital.

Such an evolution is not necessarily a force that one would wish to oppose. Indeed, one might view this transformation as a natural and positive force of economic evolution. Figure 2, by way of comparison, plots the share of agriculture in GDP. It too has declined sharply over the past decades. If we ran the chart back another 50 to 100 years, then we would see that agriculture has declined from about 90 percent of GDP to where it is today, less than 1 percent of GDP.

Should Congress address the decline in agriculture with a law that mirrors the current proposal? Such a policy, clearly, would seek to reverse a trend that should not be reversed; to reverse progress itself. The same may be true for manufacturing.

---

[1] Corrado, et al., 2006

It is true, however, that a change in the composition of GDP that reflects progress is highly relevant for those affected. There are regions in the United States that historically have been centers of manufacturing, just as there are regions that have been centers of agriculture. As the composition of our activity changes, those regions bear a disproportionate share of the harm, and provide us with a special policy imperative to ease the pain of transition. In these instances, it may be beneficial for Congress to intercede and provide education that better prepares workers for the new economy.

The optimality of neutral economic policy

Ever since the seminal work of Diamond and Mirrlees in 1971, economists have known that optimal economic policy should not tax intermediate goods or distort productive efficiency[2]. This means that the allocation of capital that emerges in response to market forces should not be disrupted by special treatment for some inputs but not others.

The Diamond and Mirrlees result indicates that an optimal policy will not favor production in one area at the expense of another. The Act we are discussing today appears to insist that manufacturing receive special treatment that advantages manufacturing relative to everything else. Such a focus of policy is not defensible on economic grounds.

If business activity is viewed by Congress to be disappointingly low, then it is wholly appropriate to consider measures that would stimulate it across the board. But when politicians pick winners and losers, they interfere in the natural economic process, and inevitably cause harm. If the members of this committee believe that they know better than the market where profitable opportunities lie, then they should retire from Congress, start businesses, and grow rich.

What can increase business activity in the U.S.?

In my many years in Washington, I have acquired the opinion that we tend to appoint task forces and commissions when we know what the right thing to do is, but are unwilling to do it. Commissions and task forces make for nice speechifying, but almost always have a negative policy impact because they allow elected officials to appear to be addressing key problems without actually doing anything.

Business activity in our nation is indisputably disappointing at the present time. It is urgent that policy changes be enacted before it is too late. But we do not need a commission or task force to study the issue. We know why the business climate in the United States is so terrible. The biggest problem is our corporate tax system.

---

[2] Diamond and Mirrlees, 1971.

Figure 3 plots the U.S. corporate tax rate from 1981 to 2010, and compares it to the average tax rate of our OECD trading partners. Currently, the U.S. tax rate is 35 percent, and the average for the OECD is 23.9 percent. I should note that this chart understates our disadvantage because it excludes state and local taxation.

Suppose you were a businessman planning to locate a new business in one of two U.S. states. Suppose also that one state had a corporate tax rate of 35 percent, while the other had a rate of 23.9 percent. Where would you be most likely to locate? The same force operates on an international level, and is bleeding our manufacturing sector and the rest of our economy dry.

While the manufacturing tax in the U.S. is slightly lower, it is still well above the OECD average.

If we did reduce the corporate tax, it would not favor manufacturing per se, but it would significantly improve our manufacturing climate, and benefit hard hit U.S. workers. A recent study of the impact of corporate taxes on the manufacturing sector that I coauthored with Aparna Mathur looked at the impact of corporate tax rates on the wages of blue collar workers in a sample that covered 72 countries for 22 years. We found that countries that reduce their corporate tax rate saw large and statistically significant increases in manufacturing wages.[3]

Even though the policy is neutral in the sense of Diamond and Mirrlees, lower taxes may disproportionately benefit manufacturing because they reduce a harm that is disproportionate. The harm may be disproportionate because goods production is easier than service provision to move to a lower tax environment.

If we want to revive manufacturing in the U.S., it is obvious what needs to be done. We need to give firms a reason to locate here, and a reason to stay here rather than relocate abroad. If we don't, we can appoint all the task forces and devise all the strategies we want, and they will not make a bit of difference.

Notes on the specific legislation

While, in the abstract, it is impossible to oppose having a strategy or performing a study, I am concerned about what that strategy might entail. The development of a strategy and performance of the Task Force could well be beneficial, but the bill as written looks to be an invitation for destructive meddling. In particular, the biggest cause for concern is the possibility that the Act be used as an excuse to increase protectionism.

The language of the Act seems to invite anti-trade actions and to glorify central planning. Many of the catch words used by protectionists are present in the wording of the bill, including charges to monitor specific industries that face

[3] Hassett and Mathur, 2006.

"critical" challenges and the "identification of emerging or evolving markets, technologies and products that the Nation's manufacturers could compete for." Is the government to pick winners and losers within the manufacturing sector? While it is clear that at some point a manufacturing capability has national defense implications, even this angle is subject to abuse by protectionists. Are we to make sure that we have a vibrant clothing manufacturing industry for fear our troops might be forced to fight without uniforms?

It would be easy to envision that a strategy to enhance manufacturing in the U.S. might bear a striking resemblance to the policy sought by Bastiat's candlemakers, who argued that the government should pass a law requiring individuals to keep their window shades down during the day because of the unfair competition from the sun. Such a policy would, of course, increase the demand for candles, but would it make us better off?

The pernicious government meddling that this Act may invite is perhaps best illustrated by the emphasis that policies should promote "sustainable" growth. As Nobel winning economist Robert Solow has written, the notion of sustainability is extraordinarily elusive.[4]

"It is very hard to be against sustainability," Solow wrote, "the less you know about it, the better it sounds." To carry sustainability out literally, Solow writes, would be to "make no use of mineral resources; it would mean to do no permanent construction or semi-permanent construction; build no roads; build no dams; build no piers." While the notion of leaving the world the same way we leave a campsite, without a trace of our presence, seems romantically attractive, "I doubt," Solow writes, "that I would feel myself better off if I had found the world exactly as the Iroquois left it."

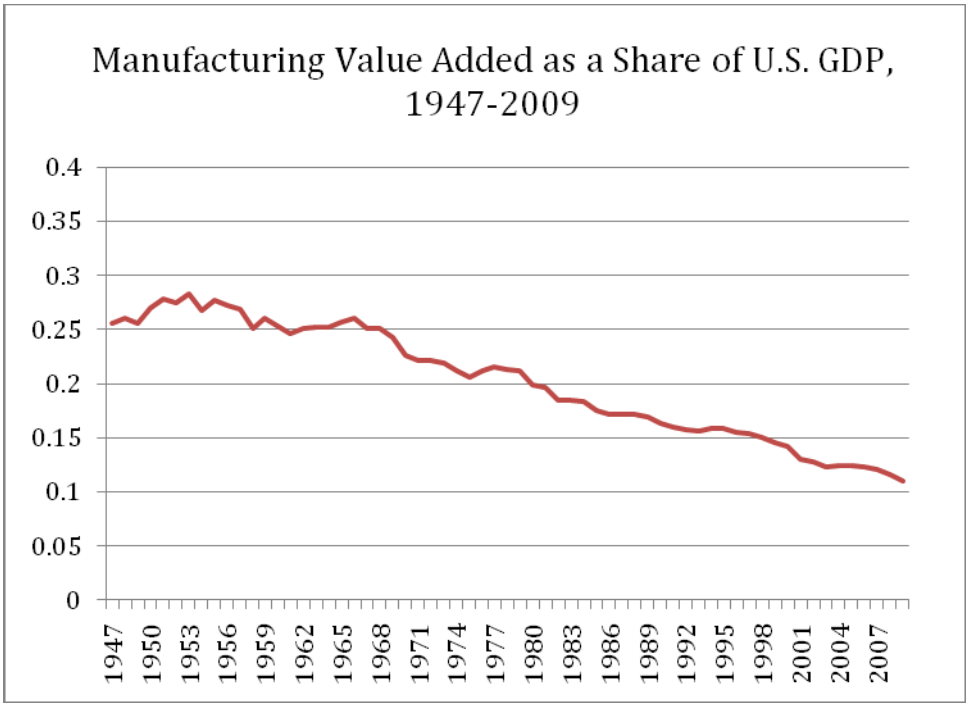
Solow struggles in his piece, and develops a definition of sustainability that is, to an economist, sensible, but seems quite far removed from the nebulous notion that those who invoke the word have in mind. But the key point is that the Act seems to place a high priority on creating a strategy for sustainable growth, even though, again quoting Solow, "sustainability is an essentially vague concept, and it would be wrong think of it as being precise, or even capable of being made precise. It is therefore probably not in any clear way an exact guide to policy."

It is hard to conceive of what good would be accomplished by the elevation of this notion to a place at the center of U.S. manufacturing policy, but easy to conceive of bads that might follow. On balance, the same can be said for the entire Act.

---

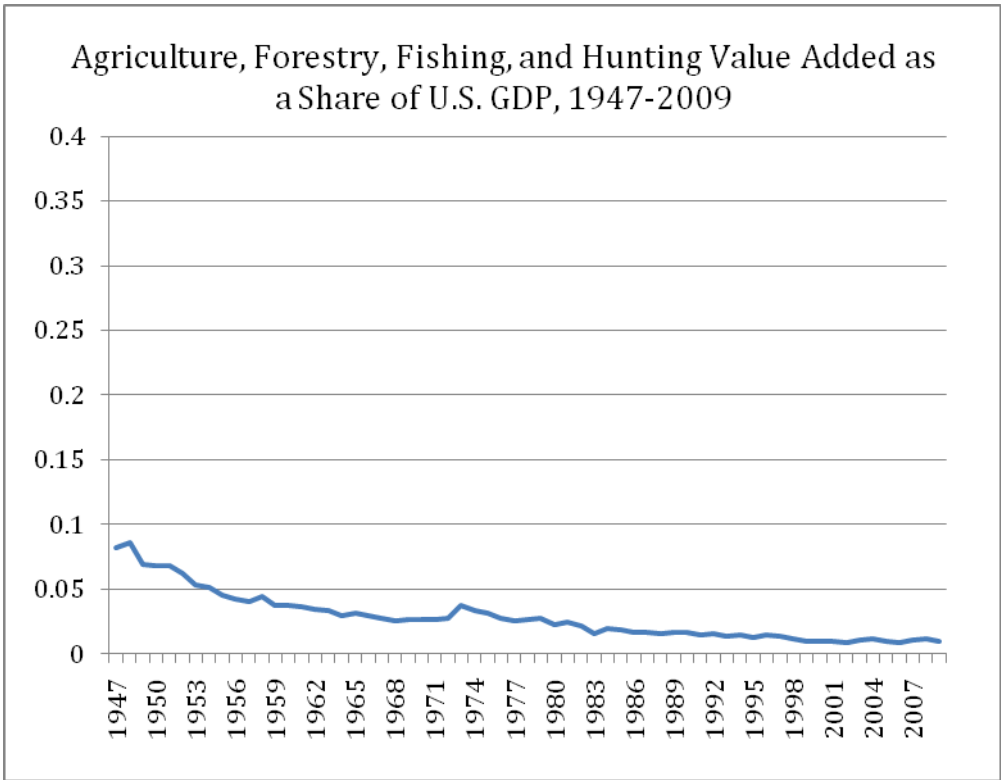
[4] Solow, 1993.

Figure 1:



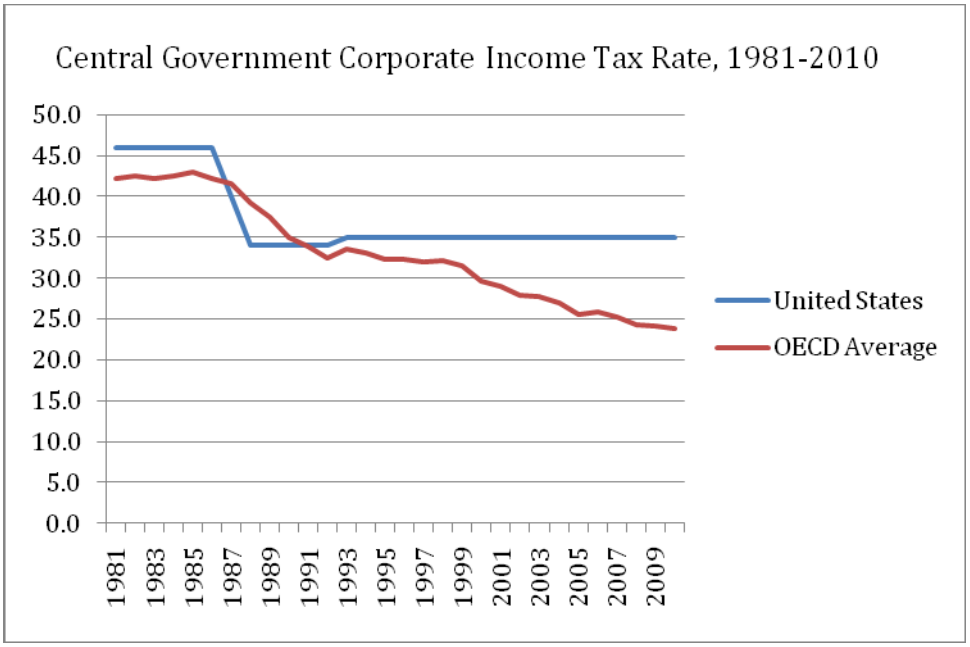
SOURCE: Bureau of Economic Analysis

Figure 2:



SOURCE: Bureau of Economic Analysis

Figure 3:



SOURCE: OECD

References

Corrado, C., Hulten, C., and D. Sichel (2006), "The Contribution of Intangible Investments to US Economic Growth: A Sources-of-growth Analysis", NBER Working Paper 11948.

Diamond, Peter A., and James A. Mirrlees. "Optimal Taxation and Public Production II: Tax Rules." The American Economic Review 61.3, Part 1 (1971): 261-78. <http://proxy.lib.duke.edu:2192/stable/1813425>.

Hassett, Kevin, and Aparna Mathur. 2006. "Taxes and Wages," American Enterprise Institute Working Paper #128. http://www.aei.org/docLib/20060602_HassettMathur.pdf

Solow R. 1993. Sustainability: an economist's perspective. In Selected Readings in Environmental Economics, ed. R Dorfman, NS Dorfman, pp. 179- 87. New York: Norton. 517 pp. http://www.isites.harvard.edu/fs/docs/icb.topic203569.files/Solow.Sustainability_An_Economists_Perspective._1993.pdf