

VI. IS THERE A FUTURE FOR MANUFACTURING?

The Visible Hand of U.S. Deindustrialization

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Abstract

In recent years, the U.S. manufacturing sector has seen both its share of output and total employment decline, a problematic trend given the manufacturing economy's essential contribution to economic growth, prosperity and macroeconomic stability. The empirical evidence indicates that manufacturing's decline is attributable to a specific set of economic policies. Hence, there are clear policy measures that could be taken to address the manufacturing sector's decline and to stabilize growth prospects for the U.S. economy.

Across the manufacturing sector, sophisticated industries that once served as the backbone of U.S. economic prosperity are dwindling in terms of both output and employment. Evidence of this U.S. deindustrialization should be raising red flags for U.S. policy makers, given manufacturing's long-recognized contribution to economic growth and prosperity, as well as the problematic manufacturing-driven trade and current account deficits (for more detail, see Hersh 2003). But rather than suffering through sleepless nights, U.S. policy makers have met manufacturing's decline with a series of public policy choices that place U.S. manufacturing at a competitive disadvantage against foreign producers and provide perverse incentives for companies to relocate manufacturing overseas. In other words, U.S. deindustrialization is not simply a result of natural economic evolution, but also owes to policy makers' remarkable indifference to the manufacturing economy. Manufacturing still matters

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for continued and growing U.S. economic prosperity. Its importance demands that we reevaluate policies that have led to manufacturing's decline.

The Visible Hand of Manufacturing Decline

Whereas some countries pursue industrial policies to bolster their manufacturing industries, the trifecta of U.S. trade policy, "strong dollar" policy, and fiscal policy may be more aptly described as a *deindustrial* policy. Also contributing to U.S. manufacturing's decline are changing structures of corporate governance and executive compensation that deterred productive investment in manufacturing in pursuit of capital gains in the late 1990s.

Trade Policy

The proliferation of regional, bilateral, and multilateral trade liberalization agreements throughout the 1990s reduced tariffs and quotas across the board in most countries; however, nontariff barriers (NTBs) to trade in both high-wage and low-wage competing countries remain prosaic. Available data on the incidence and level of NTBs leave much to be desired, but a pattern of protectionism faced by U.S. manufacturers is nonetheless clear (Michalopoulos 1999; Sazanami et al. 1994; United States Trade Representative 2002). Though U.S. manufactures face stiff NTBs abroad, the United States imposes virtually no tariff or nontariff controls on manufactured imports (Organization for Economic Cooperation and Development 1997).

In many ways, the United States has backed itself into a corner with trade policy. While continuing to face numerous barriers abroad, through a series of multilateral and bilateral agreements the United States has reduced its own barriers to imports to negligible levels across the board (U.S. International Trade Commission 2002). With tariffs and NTBs already so low the United States has little capital left with which to bargain for reduced barriers to foreign markets or for establishing labor rights and environmental standards. Absent many bargaining chips, the current U.S. Trade Ambassador has expressed willingness to negotiate U.S. antidumping laws designed to shelter domestic producers from uncompetitive foreign practices—despite explicit instructions from the U.S. Congress not to do so.

The U.S. Export-Import Bank (XM), created by Congress in 1934 to promote exports, is instead subsidizing the export of manufacturing capacity and jobs—even entire factories—that competes directly with U.S. producers and workers. XM Bank projects have financed the export of metal manufacturing equipment to China, Mexico, Korea, and Romania, and semiconductor manufacturing equipment to Malaysia (U.S. Export-Import Bank 1997–2001). Currently, the XM Bank is considering close to \$50 million in projects financing the export to Mexico of factories for manufacturing automotive crankshafts

and aluminum engine blocks, with the output intended for reimport to the United States (Wayne 2002). In some cases, these companies were later found by the International Trade Commission to be dumping their products below cost on the U.S. market.

Dollar Policy

Between 1995 and the beginning of 2002, the U.S. dollar appreciated by 30 percent versus a weighted basket of foreign currencies (Federal Reserve Board of Governors 2002). While U.S. policy floating exchange regime entrusts the dollar's value to the market, market forces once again produced a severe misalignment of foreign exchange rates to the detriment of U.S. industry. This run-up in the dollar's value stems not from explicit policy actions on the part of either administration, but from a number of economic developments in the late 1990s that attracted foreign capital to U.S. markets (Blecker 2002). Both the Clinton and Bush administrations, however, held the rising dollar as desirable in their calculus of political power, and thus both allowed the dollar to rise in value, denying its overvaluation and refraining from action to keep the dollar at a sustainable level (Weller and Singleton 2002).

The value of the dollar is an important determinant of competitiveness in markets for internationally traded goods such as manufactures, making U.S. manufactures more expensive and foreign manufactures cheaper to consume. What followed was a proliferation of manufacturing imports while manufacturing exports remained stagnant and then tapered off, causing an acceleration of the overall trade deficit. It is important to note that the loss of competitiveness by U.S. manufacturers due to the rise in the dollar's value is unrelated to the efficiency of individual firms. Nonetheless, the effect of the overvalued dollar for manufacturing has been severe. Blecker (2002) estimates that, by the first quarter of 2002, manufacturing profits were nearly \$100 billion lower (at an annual rate) as a result of the dollar's appreciation since 1995. The grim outlook for U.S. manufacturers, given the overvalued dollar, discouraged investment in domestic manufacturing to the tune of \$37 billion in 2001 (Blecker 2002). Blecker (2002) further estimates that nearly half of the 1.6 million manufacturing jobs lost since 1995 can be attributed to the dollar's rapid appreciation during this period.

Large manufacturing companies could capitalize on the high value of the dollar by relocating production overseas—either by building new factories, buying existing ones, or outsourcing production—where they could pay for inputs to production with undervalued foreign currencies while earning overvalued dollar revenues on sales to the U.S. market. Smaller firms, lacking the means to move overseas, were forced to cut their profits, incur losses, or simply close their doors. Prolonged overvaluation of the dollar may permanent-

ly cost U.S. manufacturers global market shares and distribution networks (Ceglowski 1989).

Fiscal Policy

Three provisions of U.S. tax law provide incentives for U.S. firms to move factories and manufacturing jobs overseas that produce goods for U.S. consumption. First, foreign subsidiaries of U.S. multinational corporations (MNCs), or foreign-controlled corporations, are not required to pay U.S. corporate income taxes until the income is repatriated from abroad. Repatriation of this income can be deferred indefinitely. A recent study by the U.S. General Accounting Office found that foreign controlled corporations are less likely to pay U.S. taxes than U.S. corporations; moreover, a greater concentration of foreign controlled corporations exists in manufacturing industries (U.S. General Accounting Office 1999). As a rule, the more extensive the network of foreign operations for an MNC, the higher the degree of tax avoidance (Rego 2002). Second, a foreign tax credit is allowed against taxes paid to foreign governments. Excess foreign taxes in one country can be applied to foreign income in other countries, often resulting in zero taxes being paid on foreign income (Shay 2002). From 1996 to 2002, MNCs received \$12.7 billion in U.S. tax subsidies on their deferred income from controlled foreign corporations (McIntyre 1996).

Third, complementing the two prior provisions are rules governing transfer pricing, the hypothetical prices derived for transactions between units within an MNC. Nearly half of all U.S. trade now occurs between such related parties; in manufacturing industries such as computers and electronics and transportation equipment, related-party trade accounts for two-thirds to three-quarters of the total (U.S. Census Bureau 2002). A guiding principle of transfer pricing stipulates that transactions be priced as if they occur "at arm's length" to prevent accounting practices that distribute profits and costs among the firms' branches in a kind of arbitrage to minimize taxation (in some cases entirely eliminating taxes or resulting in negative taxation). In practice, U.S. authorities must rely on self-reporting in monitoring compliance with transfer pricing (U.S. General Accounting Office 1992). Recent studies found that opportunities to exploit transfer pricing do play a significant role in determining firms' choices of investment location (Grubert 2002).

Corporate Governance

Evolving structures of corporate governance are changing the way corporations allocate their resources internally, affecting the availability of funds for investments in fixed manufacturing assets. Since the "shareholder revolution" of the early 1980s, the concentration of financial assets in the hands of insti-

tutional investors has helped shift the allocation of corporate resources toward generation and maintenance of “shareholder value” (i.e., high and growing share prices). To achieve this revolution, institutional investors reshaped the incentive structure with the use of stock options and stock grants to align the interests of managers with the goal of raising corporate share prices and preventing corporate takeovers (O’Sullivan 2000). In order to keep stock prices high in defense of corporate buyouts and to improve executive compensation, corporate management dedicated a growing proportion of retained earnings to buy back their own shares and to pay dividends (Liang and Sharpe 1999). Liang and Sharpe (1999) estimate that corporations will need to dedicate nearly all their future earnings to shareholder payouts just to keep pace with stock option grants and share repurchases.

Weller and Helppie (2002) found that such a reorientation of investment priorities from fixed assets toward share repurchases significantly impeded investment in manufacturing in the 1990s. Whereas the stock market reached historic highs in the late 1990s, business investment over the last business cycle averaged 11.4 percent of gross domestic product, or below the levels of the 1970s and 1980s. Low levels of net investment led to deterioration of the capital stock in manufacturing. The share of manufacturing assets fell to 17.8 percent of all private nonresidential fixed assets in the 1990s, its lowest level during the entire post-World War II era. The evidence suggests that a different corporate governance regime may have resulted in higher investment levels.

Conclusion and Policy Implications

U.S. deindustrialization can be traced to policy choices that neglect the well-established contribution of manufacturing industries to continued high and growing U.S. economic prosperity. While other countries are engaging in industrial policies that encourage the growth and vitality of manufacturing industries, the United States is engaged in a *deindustrial* policy, indifferent to the economic consequences of letting manufacturing industries slip away. Rectifying this crisis in U.S. manufacturing will require a reconsideration, and even a reversal, of past policies that have caused the United States to shed its manufacturing capacity at such an astounding rate. Only by addressing the problems inherent in U.S. trade policy, the “strong dollar” policy, fiscal policy, and cannibalistic corporate governance can we hope to end the siphoning of U.S. manufacturing.

A strategic pause is called for in the negotiation and ratification of any new trade agreements. Past trade agreements have only fueled the U.S. economy’s propensity to consume imports in excess of exports, thus driving manufacturing-led trade and current account deficits to record highs and ever nearer to an impending macroeconomic crisis. Moreover, past trade agreements have

created comparative advantages for countries that eschew labor, environmental, and public health rights, thus sparking a “race to the bottom” to undermine protections for workers and society at large. The United States has little left with which to bargain for remedying flaws in past agreements that add to the imbalances in U.S. trade. Until policy makers can disencumber the causes and consequences of the burgeoning trade and current account deficits, and can ensure basic standards of protection and human rights, all new efforts for trade liberalization should be shelved.

A coordinated policy is needed to ease the overvalued U.S. dollar and to prevent future currency misalignments that impair U.S. manufacturing. First, the dollar’s value needs to be lowered in a gradual, orderly fashion to undo the run-up in value since 1995. Second, U.S. and foreign policy makers should revisit the idea of a managed-floating exchange rate arrangement similar to the one outlined by Weller and Singleton (2002). A managed-floating arrangement could provide the predictability that foreign exchange markets and exporters need to operate efficiently and prevent detrimental currency misalignments in the future.

U.S. policy makers should close the corporate welfare loopholes that amount to billions of dollars in subsidies for the export of U.S. manufacturing jobs and industries. Policy makers should also offer incentives for corporate decision makers—managers and shareholders—to prioritize productive investments over other uses of funds by making mandatory the expensing of stock options and devising rules that encourage and enable more shareholder activism.

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