Institute for Research on the Economics of Taxation.

THE AMERICAN JOBS AND MANUFACTURING PRESERVATION ACT

Statement by
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Outline of Statement

- Concern for the status of the manufacturing sector of the U.S. economy and employment in that sector is well taken, but not effectively addressed by H.R. 2889. A new tariff-cum-tax wall against imports, such as in this bill, will injure the domestic economy and result in significant losses of well being for all Americans.

- The view that imports cost domestic jobs is analytically wrong, and at odds with the historical data.

- Trade necessarily involves dislocation. Constructive public policy should expand opportunities for those who incur private costs as a result of trade, rather than sacrificing the benefits of trade for the majority.

- Federal regulatory, tax, and spending policies raise business costs, resulting in lower levels of output, employment, and real wages. The constructive approach to improving the health of the manufacturing sector and increasing employment opportunities in that sector is to reduce these disincentives.

- A number of major tax revisions would reduce business costs and expand employment and output in the manufacturing sector.

Mr. Chairman, members of the Committee, I appreciate the opportunity to appear today to present my views concerning H.R. 2889, the "American Jobs and Manufacturing Preservation Act of 1991."

The concern of the bill's authors for the status of the manufacturing sector of the U.S. economy and for employment in that sector is certainly well taken. The remedies proposed in H.R. 2889, however, do not effectively address those concerns. On the contrary, enactment of the bill would result in significant losses of well being for all Americans. Neither domestic manufacturing output nor employment would be increased, but the economy as a whole would suffer the loss of the benefits of international trade. The perception that the domestic manufacturing sector is ailing because American business chooses to locate production facilities and activities abroad is at odds with reality. Changes in the tax laws should not be enacted on the basis of this misperception.

The view that imports cost domestic jobs is analytically wrong and perhaps more persuasively, at odds with the facts. Those who hold this view should remember a simple and basic fact of economic life: the balance of payments balances. If we restrict imports, we either will export less or we will invest more abroad, or both. Presumably, the same "reasoning" that says that imports cost us jobs also holds that exports create jobs. So, if our exports suffer because we import less, we can realize no gain in employment. Those who fear that imports cost us jobs also seem to believe that investing and operating abroad costs us jobs. If that were the case, if we were to import less while somehow or other maintaining our exports, we would have to invest more abroad, and in this case, too, according to this same argument, we would realize no gain in employment.

Limiting imports, no matter how, deprives us of the benefits of trade. Limiting imports won't produce more jobs, but it will ensure that we will use our labor and capital resources less productively than otherwise.

The historical data sturdily testify to the validity of the analytical conclusion. Surely if there were a negative relationship between imports and domestic manufacturing employment, this would immediately spring out from comparison of changes in U.S. manufacturing jobs and changes in our imports. In fact, as the charts show, there is no such relationship. A simple least-squares regression of manufacturing employment on real (1982 constant dollar) imports over the years 1947-1990 shows no significant negative correlation between these economic variables. Indeed, in 36 of the 44 years manufacturing employment increased when imports increased and fell when imports decreased; manufacturing employment and imports moved in opposite directions in only 8 of those years. If the comparison is confined to manufacturing jobs and merchandise imports excluding petroleum and petroleum products, for which data are available for the 25 years 1965 through 1989, inclusive, one finds again no statistically significant correlation, but one also discovers that the changes in employment and in imports moved in the same direction in 17 of those years and in opposite directions in only 8 years. If anything, one might better conclude from these comparisons that imports create domestic manufacturing jobs, rather than destroy them.

Protectionist trade policies are based on naive notions about the international economy. One of these notions is that production abroad of products and services to be sold in the United States is at the expense of our domestic production, employment, and income. Another notion is that production at home of products and service to be sold elsewhere expands domestic employment, output, and income. Protectionist tax policies rely on virtually identical ideas: investment by U.S. multinationals in foreign ventures is at the expense of domestic investment, and the production by U.S. controlled foreign corporations is at the expense of production that would otherwise occur in the domestic U.S. economy. Both notions are mistaken.

A company invests in facilities and undertakes operation in a foreign location for one or both of two reasons. One reason is that penetrating the foreign market requires establishing an operating presence in it, even if most of what will be sold in that market is produced here at home. The second reason is that one or more costs, including taxes, are enough lower in the foreign location to afford the company higher profit margins and a greater return on investment than can be realized by producing the products or services in the United States. The foreign production is sold in both the foreign and the domestic U.S. markets at lower unit prices than those at which it could be profitably sold if made here, or in greater quantity at the prices that would be required for domestic production.

Note that the same reasons apply to a foreign-owned company operating in the foreign location, and the results are the same as in the case of the U.S.-owned foreign company. Whatever may be the results of imports into the domestic U.S. economy, they are the same whether the producer of the imports is American or foreign owned. Inhibiting American businesses from producing abroad doesn't protect domestic jobs from foreign production; it merely discriminates against American businesses in favor of foreign companies.

Are those results of imports injurious? As users or consumers of the lower-cost foreign-produced products, Americans clearly are better off because they can buy a given amount of a product at lower prices or a larger quantity of the product at the same price by importing rather than by insisting on domestic production. They are equally well served by the lower prices or greater volume, no matter whether an American-owned or foreign-owned company is the producer of the imports. As a producer of the products, the U.S. company and its owners are clearly better off in choosing the lower-cost foreign location. Are the company's employees, actual or potential, who are not employed because the production occurs abroad injured by this location choice?

To assert that employees are injured, one would have to show that (1) these employees are completely specialized to the production of the product that is produced abroad so that if they are not employed producing this product, they can't be employed at all, and/or (2) the U.S.-owned foreign company has a complete monopoly on the product so that no foreign-owned company could take advantage of the economies available in the foreign location, produce the same product or one that is a very close substitute, and sell it in the U.S. market at a lower price than that at which the domestically-produced product would have to be sold. Neither of these conditions prevail in the real world. The domestic employment consequences of foreign production, whether by a foreign-owned company or a U.S.-controlled foreign corporation, are not fewer jobs but different ones.

Trade necessarily involves dislocation. Persons who are not employed in a particular line of work producing a particular product because the product is produced at lower cost abroad must incur the costs of relocation, geographical or occupational, and these private costs should not be disregarded. To attempt to avert or moderate these costs by restricting imports or by insisting on domestic production of products aimed at domestic or foreign markets imposes much larger social costs. Good public policy should be guided by recognition of the social gains from efficiency-dictated location choices and should not sacrifice these gains by protecting the employment status quo.

This tension between the interests of particular groups that incur dislocation costs because of trade developments and the vast majority of the population who realize substantial gains from trade is commonplace. It is the substance of the seemingly endless conflict between protectionists and free traders in the policy-making community. Resolution of the conflict should take the course of expanding opportunities for those incurring the costs of the trade development, rather than that of restricting the benefits to the majority for the advantage of the few. H.R. 2889, I fear, follows the latter course, instead of the constructive former course.

H.R. 2889, in essence, seeks to restrict imports from U.S. controlled foreign corporations by increasing the present value of the income tax liabilities of the U.S. shareholders of the CFCs, when the CFCs export to the domestic U.S. market. In effect, H.R. 2889 proposes to impose a selective tariff on such imports. If enacted, it will cost America the benefits that trade provides; it will afford no benefits of additional employment here at home.

The notion that foreign investment and operations by U.S. multinational companies are at the expense of domestic U.S. jobs is predicated on the unfounded belief that the investment and operations would otherwise be undertaken here at home. According to this belief, the U.S. parent is bound to undertake the investment and operations somewhere, apparently without regard to the rate of return on the investment or the profitability of the operations. This clearly is not the case. Every business continuously confronts a threshold rate of return in its decisions about whether to commit resources to any venture; if the business ignores this constraint, it soon finds that it can no longer acquire resources for ventures that fail to meet the profitability test. Indeed, it is likely to find itself under new ownership and management.

Underlying this "if not there, here" notion is the erroneous assumption that during any given period of time there is a fixed amount of saving available in the economy, so that any of this saving that is directed into investment abroad necessarily reduces investment at home.

The corollary proposition, equally mistaken, is that insofar as we prevent saving from being invested abroad it will be invested here at home, irrespective of how low the rate of return may be.

We can't make business ventures, investment, employment, and production profitable in the United States by making the same ventures unprofitable for American businesses operating abroad. An isolationist trade and tax policy will not make U.S. manufacturing more efficient and competitive; it will not enhance productivity of labor in domestic manufacturing activity; it will not, therefore, increase the demand for labor services in the domestic manufacturing sector. It will, on the contrary, make us less competitive in all sectors, and make gains in employment and real wages more difficult to attain.

Policy makers should recognize that a "fortress America" approach in tax policy punishes the entire American economy, not merely U.S. multinationals. The contemporary global economy in which most American businesses must operate is characterized by the across-the-border movement of products as they move from one production stage to another. The notion of national products is antique. American content does not now, any more than it ever did, afford a useful policy-making criterion.

I began this discussion by agreeing that policy makers should be concerned about the health of the manufacturing sector of our economy and about employment opportunities in that sector. The constructive approach to dealing with this concern, I submit, is not to impose a new tariff-cum-tax wall against imports, no matter who the foreign producer may be, but to reduce the disincentives that public policy has created for domestic manufacturing activity.

For one thing, public policy makers should critically examine the current regulatory, tax, and spending policies of the federal government to identify the effects of these policies on business costs. Public policies that raise business costs erode the profitability of affected businesses. The response of these businesses is to curtail operations and to contract the scale of their operations to the point at which some minimally acceptable rate of profit can be realized. The consequences are lower levels of output, employment, and real wages.

To a distressing extent, the escalation of American business costs is attributable to public policy developments. Public expenditure policies are a major source of upward cost pressures. With few exceptions, government spending programs raise the costs of production inputs to the private sector, because government either preempts these resources, bidding up their costs in private uses, or through transfer programs, raises their reservation prices for productive employment. The expansion of government spending, moreover, is a prime mover for raising taxes, which year after year are a higher and higher part of total business costs and also exert upward pressure on the supply prices of production inputs. Public regulatory policies are, for the most part, virtually equivalent to taxes on the regulated activities, and like explicit taxes, raise business costs. However worthy the objectives of government spending and regulatory programs may be deemed to be, policy makers should not overlook the costs these programs impose and the consequences of these higher costs. If there is a solid basis for concern about the failure of manufacturing employment to grow, policy makers should carefully assess the costs of the programs and policies they enact.

There are a number of major tax revisions that can be made to reduce business costs and expand employment and output in the manufacturing sector. High on the list should be repeal of the corporate alternative minimum tax, which is appropriately characterized as an excise tax on growth. The principal "tax preference" that triggers AMT liability is the difference between depreciation for regular tax and AMT purposes. Ironically, the Tax Reform Act of 1986 modified the Accelerated Cost Recovery rules to lengthen recovery periods, ostensibly to make them conform with economic lives and to produce cost recovery that would closely match "economic depreciation." The same legislation created the corporate AMT that specifies much slower cost recovery schedules. A company undertaking expansion or modernization of its depreciable property to enhance efficiency, productivity, and production capacity, i.e., to grow, is likely, as a result, to find itself paying a higher AMT rather than the regular corporate income tax. It is impossible to reconcile AMT with concern for expanding domestic manufacturing employment.

If repeal of AMT is too heroic a measure, its anti-growth effect should at least be moderated by drastically reducing its rate or by substantially modifying the designation of preferences, particularly by replacing the AMT capital recovery allowances with those used for ordinary income tax purposes, so that significant capital outlays would not trigger AMT's imposition.

An extremely useful and constructive tax change would be to conform capital recovery rules more closely with the requirements of tax neutrality. Tax neutrality requires expensing of outlays for depreciable property, or equivalently, multiple-year deductions in such amounts that their present value equals the costs incurred to acquire the property and put it into use. ACRS and the investment tax credit roughly approximated expensing for most depreciable personal property. TEFRA in 1982 rolled back much of the benefits of ACRS-ITC, and the 1986 act seriously impaired capital recovery provisions by repealing ITC and further curtailing ACRS.

Capital recovery provisions should be revised to conform them more closely with the neutrality standard. A limited but useful first step would be to provide a significant first-year deduction for capital outlays. For example, the deduction might be 100 percent of the first, say, $200,000 of capital outlays in the taxable year, plus, say, 10 percent of the remainder of such outlays in the year.

An obvious and powerful measure for reducing the cost of employment and increasing jobs, throughout the economy, including manufacturing, would be to reduce payroll tax rates. Payroll taxes artificially escalate unit labor costs. They increase the employer's total compensation costs, hence curtail the amount of labor services demanded by employers. At the same time, payroll taxes reduce the employees' take-home pay and raise the price that employees demand for their services, thereby curtailing labor supply. Payroll taxes that impose these excise effects on employment can't be reconciled with concerns for increasing jobs.

Payroll tax rates should be reduced, along with the compensation base to which they apply. This necessarily implies significant changes in the existing social security and medicare programs. The track record of these programs urge that they should be phased down, with responsibility for provision of retirement income and of medical care for older persons shifted back to the private sector. There is every reason to believe that this can be done without jeopardizing the situation of current beneficiaries or of persons who would become beneficiaries in the next 15 to 20 tears.

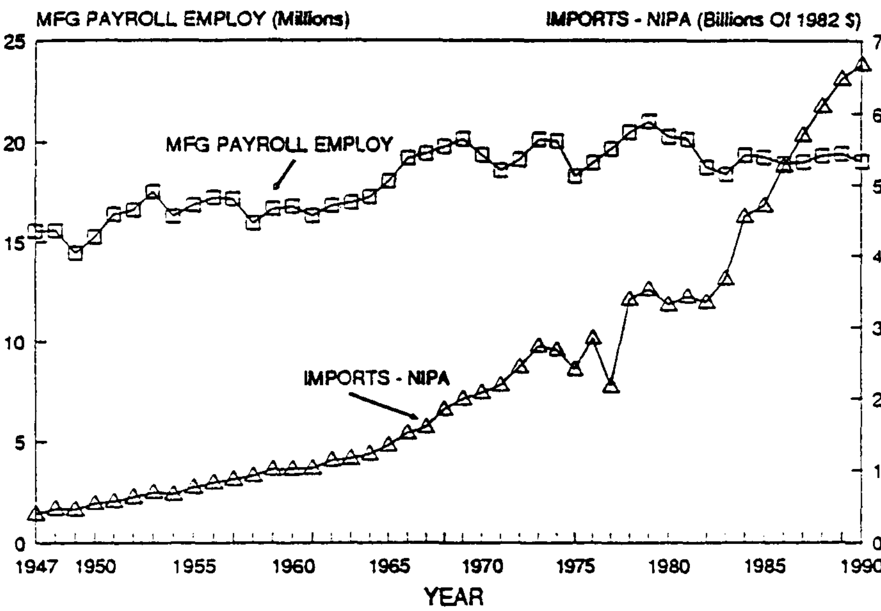
In my testimony to this Committee on July 18, 1991, I offered a number of other suggestions for tax reforms to enhance the competitiveness of American business. The same tax revisions, I strongly believe, would contribute to more rapid expansion of the domestic manufacturing sector's employment and output. I respectfully call the Committee's attention to that testimony.

These tax revisions would result in substantial reductions in federal tax revenues. These revenue losses should not be seen as a draw back. Indeed, the beneficial results for the economy should greatly outweigh any budgetary consideration. In fact, one of the most highly desirable results might be strong pressure for curbing the growth in federal outlays, thereby easing the upward pressures on business costs that government spending entails. Let me repeat a concluding observation I offered in last July's testimony. "Over the last several years, the fiscal policy has been to have revenues chase after spending. This is topsy-turvy fiscal policy. What is needed is the creation of a tax system that will least impair the efficiency and growth of our economy, and a budget policy that constrains spending to no more than that tax system generates in revenues."

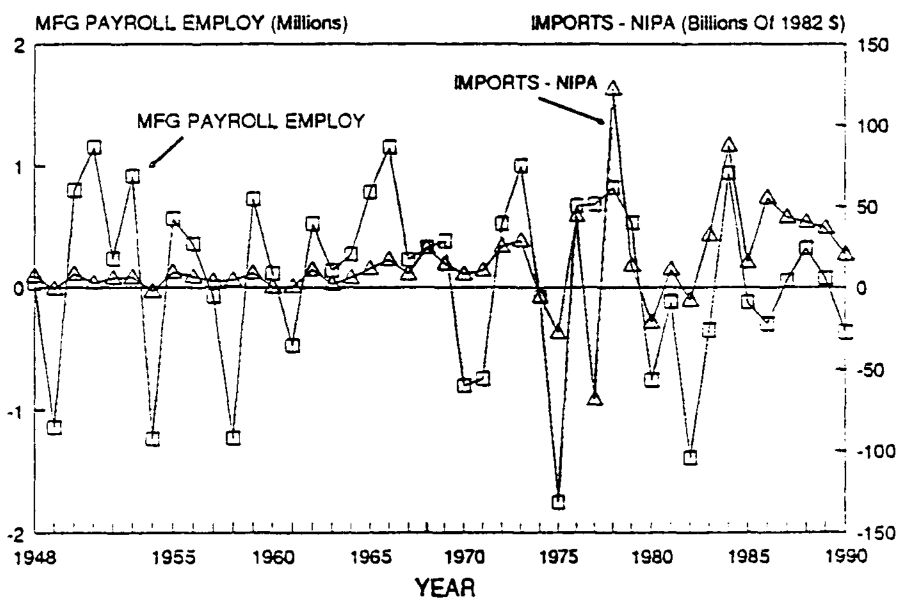
A constructive approach to expanding manufacturing employment and output must shun tax changes that would further penalize American enterprises abroad. Turning over the operations of U.S.- controlled foreign corporations to foreign-owned businesses will only injure the domestic U.S. economy. The constructive approach is to minimize the cost-increasing impact of our public policies. A good way to begin is by making our national tax policy more free market friendly.

Appendix A

REAL IMPORTS (NIPA) AND MANUFACTURING PAYROLL EMPLOYMENT, 1947-1990



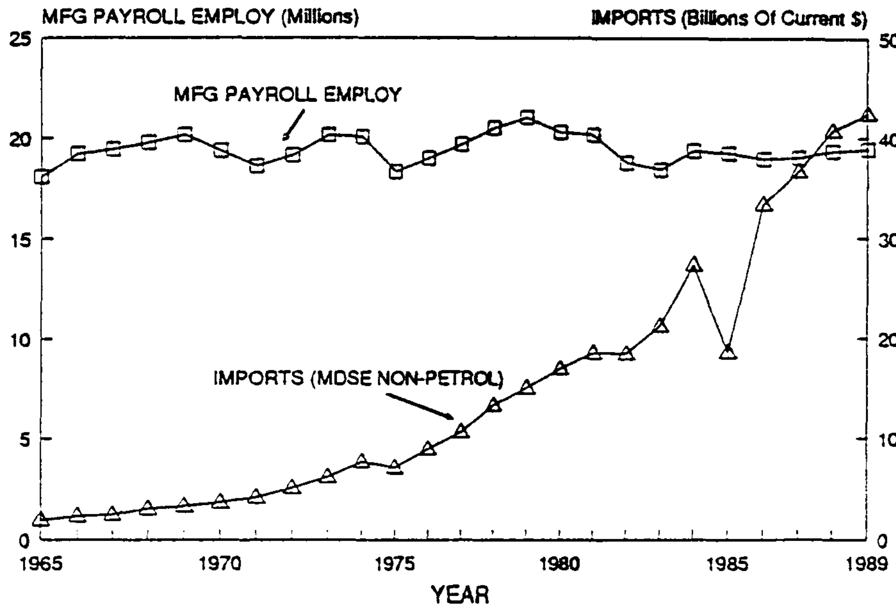
REAL IMPORTS (NIPA) AND MANUFACTURING PAYROLL EMPLOYMENT, YEAR TO YEAR CHANGES, 1948-1990



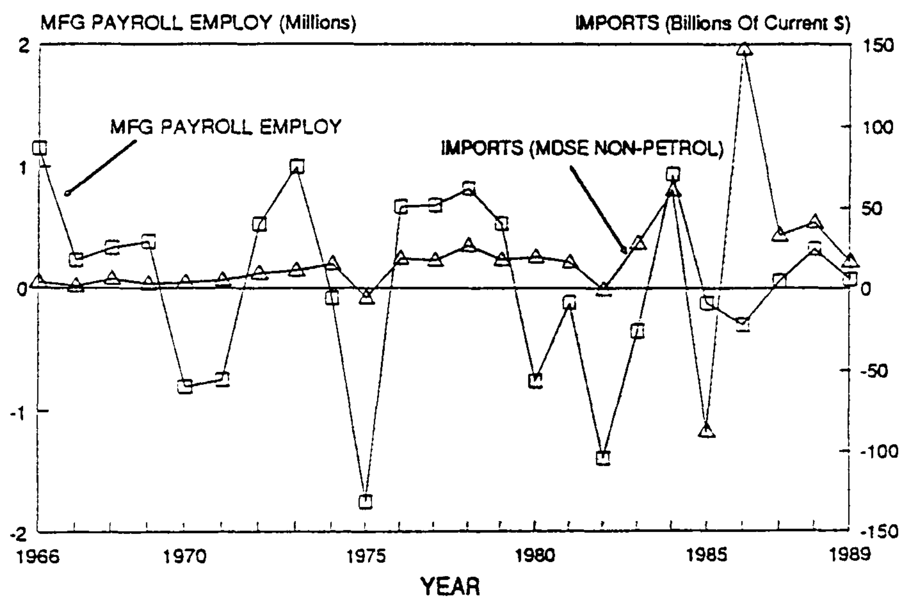
SOURCE: ECONOMIC REPORT OF THE PRESIDENT: 1991, TABLES B-2 AND B-43

Appendix B

MERCHANDISE IMPORTS EXCLUDING PETROLEUM AND MANUFACTURING PAYROLL EMPLOYMENT, 1965-1989



MERCHANDISE IMPORTS EXCLUDING PETROLEUM AND MANUFACTURING PAYROLL EMPLOYMENT, YEAR TO YEAR CHANGES, 1966-1989



SOURCE: ECONOMIC REPORT OF THE PRESIDENT: 1991, TABLES B-103 AND B-43