



Statement before the U.S. Congress Joint Economic Committee
Hearing on the State of U.S. Manufacturing

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Chairman Casey, Vice Chairman Brady, and other members of the Committee, thank you for the opportunity to appear before you this morning and discuss the U.S. manufacturing sector—a key part of our economy. The significance of manufacturing to the U.S. economy is undeniable, and the role and dynamics of this sector are important to study. It is critical to recognize, however, that manufacturing is but one segment of the U.S. economy, and the share of the resources dedicated to this sector should be determined by market forces, not government policy.

The role of policymakers should be to establish broad, effective, and stable policies that permit the U.S. economy to evolve as market forces dictate. Given that objective, policymakers should not seek to develop targeted subsidies or narrowly tailored economic policies for a single sector, not for one as large and important as manufacturing or for other smaller sectors. Instead, policymakers should promote economic growth by improving the U.S. business environment as a whole. Pursuing structural reforms will benefit the manufacturing sector directly by reducing costs and impediments and indirectly by encouraging growth across the entire economy.

There are many ways policymakers can pursue the goal of facilitating a healthy business environment for manufacturing and other sectors. Trade liberalization, corporate tax reform, education and job training, legal reforms, a comprehensive energy policy, and other infrastructure improvements are but a few. In my testimony this morning, I will focus on just one—corporate tax reform. However, it is important for the purposes of this hearing to understand the evolution of the manufacturing industry. Therefore, I will begin with an overview of the current state of manufacturing in the U.S. and the longer-term employment and productivity trends in the sector.

Recent Trends in the U.S. Manufacturing Sector

The U.S. manufacturing sector produced about 11 percent of total output and employed about 8 percent of the total workforce in 2009.¹ Manufacturing industries have been a significant driver of economic growth in the U.S. and abroad.² Manufacturing labor productivity increased 4.1 percent in the first quarter of 2011 compared to the same quarter in 2010. This compares to productivity growth in the broader nonfarm business sector of 1.3 percent for the same period.³

However, manufacturing employment has been declining in the U.S. since its peak in 1979.⁴ As Figure 1 shows, this job loss has occurred even in non-recessionary periods. The downward trend in employment coinciding with an increase in productivity in manufacturing is not unique to the United States. As shown in Figure 2, output increased while labor input (hours) decreased significantly in the manufacturing sector across a range of developed countries from 1979 to 2009.⁵

¹ Susan Fleck, John Glaser, and Shawn Sprague, “The Compensation-Productivity Gap: A Visual Essay,” *Monthly Labor Review* 134, no. 1 (January 2011), www.bls.gov/opub/mlr/2011/01/art3full.pdf.

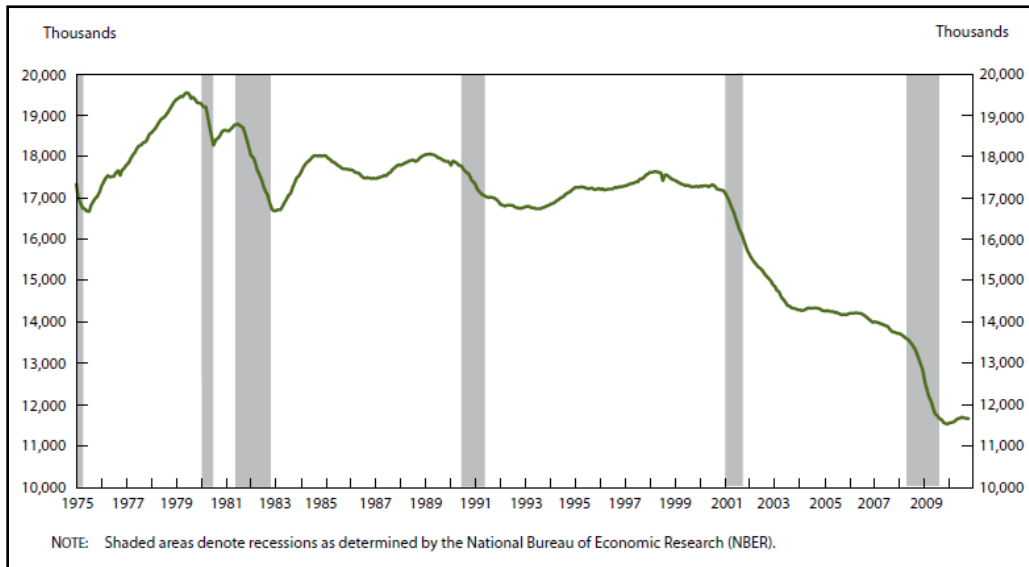
² *Engines of Growth: Manufacturing Industries in the U.S. Economy*, U.S. Department of Commerce, Economics and Statistics Administration, Office of Business and Industrial Analysis, July 1995, www.esa.doc.gov/sites/default/files/reports/documents/enginesofgrowth.pdf.

³ Bureau of Labor and Statistics (BLS), “Productivity and Costs: First Quarter 2011, Revised,” news release, June 2, 2011, www.bls.gov/news.release/pdf/prod2.pdf.

⁴ Megan M. Barker, “Manufacturing Employment Hard Hit during the 2007–09 Recession,” *Monthly Labor Review* 134, no. 4 (April 2011), www.bls.gov/opub/mlr/2011/04/art5full.pdf.

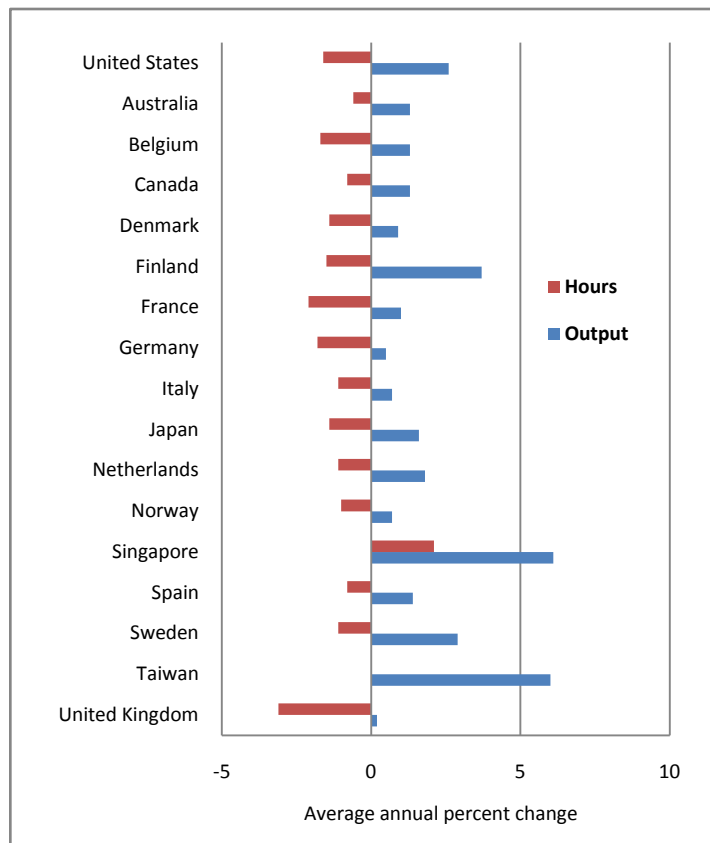
⁵ BLS, “International Comparisons of Manufacturing Productivity and Unit Labor Cost Trends, 2009,” news release, December 21, 2010, www.bls.gov/news.release/pdf/prod4.pdf.

Figure 1. U.S. Manufacturing Employment, 1975–2010



Source: Bureau of Labor Statistics (monthly data, seasonally adjusted).

Figure 2. Manufacturing Output and Hours, 1979–2009



Source: Bureau of Labor Statistics.

U.S. manufacturing employment was hit particularly hard by the recent recession. During the eighteen months of the recession, from December 2007 to June 2009, the manufacturing workforce declined by 15 percent, with more than 2 million workers losing their jobs.⁶ Job losses in the sector continued for six months after the recession officially ended, until December 2009, at which point manufacturing employment was lower than it had been since 1941.⁷ In addition to job losses, working hours of remaining employees were cut back, with total hours worked in the sector falling by 17.8 percent during the recession.⁸ As Figure 3 demonstrates, the average work week was reduced by two hours during the recession.⁹

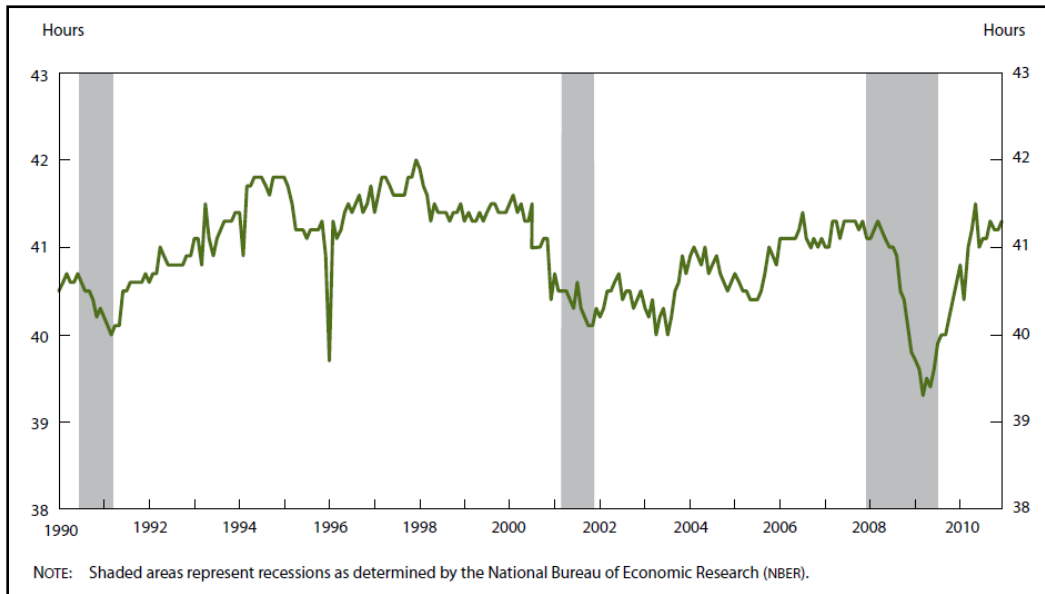
⁶ Ibid.

⁷ Ibid.

⁸ Timothy Dunne, Kyle Fee, and John Lindner, "Economic Trends: Manufacturing Hours and Employment in the Recovery," Federal Reserve Bank of Cleveland, June 7, 2011, www.clevelandfed.org/research/trends/2011/0611/01labmar.cfm.

⁹ Megan M. Barker, "Manufacturing Employment Hard Hit during the 2007–09 Recession."

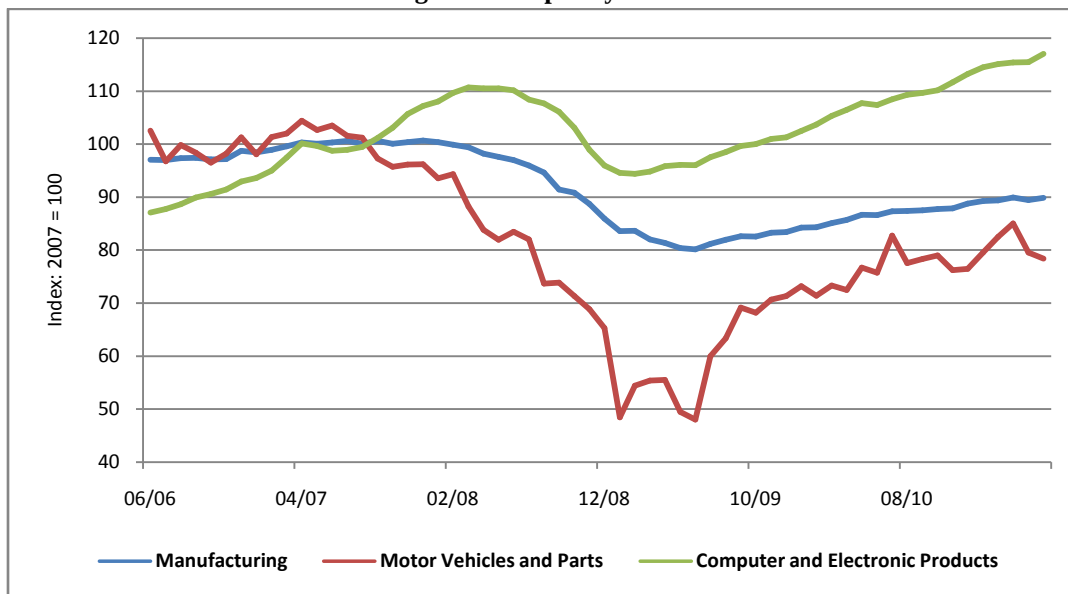
Figure 3. Average Weekly Hours of Manufacturing Production, 1990–2010



Source: Bureau of Labor Statistics (average weekly hours of manufacturing production and nonsupervisory employees, monthly data, seasonally adjusted).

Total manufacturing output also declined during the recession and has yet to fully recover. According to the Federal Reserve Board, manufacturing in the U.S. peaked in 2007 before declining 20 percent by June 2009. Since then, production has increased about 11 percent. It is important, however, to recognize the diversity within the manufacturing sector and the disparate performance of subsectors. For example, motor vehicle and parts production declined 50 percent during this same period and has recovered to about 80 percent of pre-recession levels. On the other hand, computer and electronic parts production is 17 percent above 2007 levels (see Figure 4).

Figure 4. Output by Sector



Source: Federal Reserve Board.

However, true to its reputation for driving economic growth, durable-goods manufacturing has begun to pick up and was a leading contributor in 2010 to U.S. economic growth. Manufacturing value added (which measures an industry's contribution to GDP) rose 5.8 percent in 2010.¹⁰ However, in view of the historical trends discussed above, we should not expect a sizeable increase in employment, even as output increases.

There is good news and bad news in this state of affairs. While the reduction in the amount of labor necessary for a given amount of production can reduce employment in the manufacturing sector, such productivity growth is a huge positive for workers, as it boosts wages throughout the economy. Growing consumer demand for services—another primary factor in manufacturing employment decline—is a sign of economic growth and development, as mirrored in other advanced economies, and creates new employment opportunities in the services sector.¹¹

The downward trend in manufacturing employment prompts some to conclude that the government should give special assistance to that sector. This approach is ill-advised. Policies aimed at steering resources toward one sector harm other sectors as resources are allocated from one activity to another. Subsidizing manufacturing would artificially prop up a sector that is changing due to natural market forces.

Addressing Existing Distortions

It is important for policymakers to understand the changes occurring throughout the economy, and today's hearing is an appropriate venue for gaining insight into the particular details within the manufacturing sector. However, as described earlier, the proper objective in the pursuit of fostering long-run economic growth is the adoption of broad, stable, and neutral growth policies, not targeted strategies to steer economic activity into particular segments of our economy. Before detailing one policy reform that meets this objective, it is important to recognize that myriad distortionary, non-neutral policies already exist.

One clear indication that the federal government has taken a special interest in the manufacturing sector is the existence of the Commerce Department's Manufacturing Initiative and the establishment of www.manufacturing.gov, which I consider to be an oxymoron in a free-market economy. The policies that favor manufacturing over other industries go beyond dedicated websites and agency initiatives. One such distortionary policy is a tax preference that favors manufacturing production over other forms of economic activity.

Section 199 Manufacturing Deduction. Passed in 2004, Section 199 of the Internal Revenue Code allows for producers of manufactured goods to claim a deduction of 9 percent of the value of attributable manufacturing income. Given that the corporate income tax rate is 35 percent, this deduction is approximately equivalent to a 3 percentage point reduction in the income tax rate on such income. Such "qualified production" income is defined to include not only domestic

¹⁰ Bureau of Economic Analysis, "2010 Recovery Widespread across Industries," news release, April 26, 2011, www.bea.gov/newsreleases/industry/gdpindustry/gdpindnewsrelease.htm.

¹¹ "The Manufacturing Sector," *Economic Report of the President*, chapter 2, 2004, http://fraser.stlouisfed.org/publications/erp/issue/1698/download/7523/erp2004_chapter2.pdf.

manufacturing activity but also the selling, leasing, and licensing of manufactured goods and the production of software, certain motion pictures, electricity, natural gas, agriculture, and construction services. Section 199 constitutes a tax expenditure and is estimated by the Joint Committee on Taxation to cost over \$60 billion from 2010–2014.¹²

The provision, which began in 2005 but has been in full effect only since 2010, is complex due to the difficulty in determining how to properly allocate costs and revenues between various goods and services provided by a firm. The IRS has designated the policy a “Tier 1” audit issue, and substantial paperwork requirements are associated with claiming the deduction. Section 199 can be considered a tax on non-manufacturing. This clearly violates the principles of neutrality for fostering long-run economic growth.

Recommendations and Conclusion

One way to reduce the distortion described above—and also mitigate other important harmful aspects of the corporate income tax system such as the distortions between debt and equity financing and between C-corporations and pass-through entities, and the competitive disadvantage faced by U.S. corporations competing with foreign domiciled entities—is to significantly lower the U.S. corporate income tax rate. A significant reduction would be of value to the manufacturing sector as well. Replacing Section 199 with a simple and significant reduction in the corporate rate—at least to 25 percent, if not lower—would both level the playing field between manufactured and non-manufactured production and improve the general competitiveness of all U.S. corporations. In addition, the tax simplification benefits would reduce costly tax compliance burdens imposed on the manufacturing sector.

Corporate tax reform is not the only necessary change, just one critical step that would go a long way toward achieving a more neutral fiscal policy, which will be to the long-term benefit of the manufacturing sector and the economy at large. I believe that we cannot subsidize our way to prosperity. Similarly, we cannot maximize the success of the manufacturing sector or any other sector by limiting or restricting trade. Rather, we need sound business policy that facilitates a level playing field for all industries and promotes general economic growth. Regardless of the sector in question, the goal should be neutral, efficient, long-run fiscal policy.

¹² Joint Committee on Taxation, “Estimates of Federal Tax Expenditures for Fiscal Years 2010–2014,” December 15, 2010.