Testimony

of Michael E. Baroody
Executive Vice President
National Association of Manufacturers

before the Committee on Budget
United States Senate

***on* The State of the Economy**

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Thank you Mr. Chairman and Members of the Committee. I am executive vice president of the National Association of Manufacturers and chairman of The Asbestos Alliance. In the first part of my testimony, I speak on behalf of the Alliance, a coalition led by the NAM that includes asbestos defendant companies, insurers, trade associations, and others seeking congressional legislation to help solve America's asbestos litigation crisis. While this hearing is not about asbestos litigation per se, I believe its far-reaching impact is one of a number of factors hurting the U.S. economy. In fact, I would characterize out-of-control asbestos litigation as an anchor weighing down the business community, particularly the manufacturing sector, and slowing down our overall economic recovery. Let me explain why.

For the last 18 months, newspapers and magazines have been filled with stories of skyrocketing claims, massive jury awards and bankruptcies. Asbestos litigation has already forced more than 60 companies into bankruptcy. More than one-third of those bankruptcies have occurred in the last three years. An estimated 200,000 claims are now pending. More than 90,000 were filed just in 2001, the last year for which complete data are available. Moreover, we are not by any means near the end of this story. According to some estimates, after more than 25 years, we have not yet passed the halfway mark. Ultimately, if nothing is done, we may see more than two million asbestos cases, and the ultimate cost to American business could reach $275 billion.

It would be a different matter altogether if this huge sum was the amount needed to compensate people with deadly cancers and other serious diseases caused by exposure to asbestos. But in fact, exactly the reverse is true. The heart of the problem is that asbestos claimants who are not sick today and who probably will never become sick are filing claims and winning millions of dollars. According to a report released last year by RAND, between two-thirds and 90% of all claimants are "functionally unimpaired, meaning that their asbestos exposure has not so far affected their ability to perform activities of daily life."

Let me give you an example of why this is a problem. In October 2001, a Mississippi jury awarded $150 million to six plaintiffs in an asbestos case. Each was awarded $25 million. Not one of these six men displayed any symptoms at all. In fact, the lawyer who brought the case boasted to reporters, "Most of these guys have not missed a day of work in their lives." One plaintiff even boasted in his deposition that he was a jogger.

Questionable claims like the ones in this case and the resulting settlements and verdicts are forcing companies into dire financial straits and sparking the bankruptcy filings. One of the defendants in the case I just mentioned is now bankrupt, and another saw 42% of its market value, $3.8 billion, disappear in a single day because of the financial markets' concern with asbestos liabilities. At the same time, many of those who are seriously ill from exposure to asbestos are seeing their compensation delayed and reduced. If the present course continues, there may not be any money left to pay the sick.

There are many victims of this asbestos litigation scandal, but first among them are the truly sick and their families, who may have to wait for years for inadequate compensation. For that reason, prominent plaintiffs' lawyers who represent cancer victims actively support the Alliance's proposed reforms. But there are other victims as well.

According to RAND, in 1970, there were 300 companies in asbestos litigation. Today, that number is 8,400 companies, representing virtually all U.S. industries and companies of all sizes. Many of the defendants never even made or used asbestos in their products. These range from well-known Fortune 500 multinationals to tiny firms, like a five-person company that distributes air compressors to gas stations. That small business is still trying to determine why it has been named in asbestos lawsuits!

The defendant companies are spending untold millions of dollars and resources. A total of $54 billion has been spent on asbestos litigation and, as I mentioned above, estimates of total cost range as high as $275 billion. The workers in the many impacted companies, retirees and shareholders are also paying a heavy price. Late last year, Nobel Prize-winning economist

Joseph Stiglitz did an excellent study on the impact of asbestos bankruptcies on workers. I would like to share some of his findings.

Dr. Stiglitz found that asbestos bankruptcies have put 60,000 employees out of work. Those workers and their families have lost $200 million in wages alone. Employee retirement assets have declined roughly 25%. And the direct costs of bankruptcies on the bankrupt firms have been between $325 million and $625 million. These companies, their employees, and the communities that depend on them are also victims of asbestos litigation.

While the report did not focus on the non-bankrupt firms, the authors noted that uncertainty surrounding asbestos claims raises borrowing costs and reduces equity values of solvent firms, which has a significant impact. The mere fact that a company is the target of asbestos claims—as so many are—can throw its stock into free fall. For example, when a large company announced last year that it had about 3,000 claims, its shareholders lost about 25 percent of the value of their holdings almost overnight. Only a portion of that value was regained in subsequent months.

Just last week, we received even more disturbing news about the economic impact of asbestos litigation. A U.S. Chamber of Commerce-sponsored study by National Economic Research Associates Consulting found that nationwide, there will be as much as $2 billion in additional costs borne by workers, communities and taxpayers due to indirect and induced impacts of company closings related to asbestos. The shuttering of plants and job cuts will decrease per capita income, lead to declining real estate values and dwindling federal, state and local tax receipts. Additional costs brought upon workers and communities include up to $76 million in worker retraining, $30 million in increased healthcare costs and $80 million in payment of unemployment benefits. In addition, for every 10 jobs lost directly, the community may lose 8 additional jobs.

The evidence is simply overwhelming—we are all paying the price of the asbestos litigation crisis and something must be done. Last year, your colleagues in the Senate Judiciary Committee held an asbestos hearing and both then-Chairman Leahy and new Chairman Hatch agreed that congressional legislation is essential to resolve these problems. Steve Kazan, a prominent plaintiffs' attorney was among the witnesses and he concluded his testimony by saying, "I urge you to act quickly to fix this broken and abused part of our justice system before the real victims of asbestos lose everything. Only Congress has the power to end this national nightmare." The members of The Asbestos Alliance could not agree more. We are working diligently with the Senate and House to try to get legislation passed this year. It is essential not only to ensure that the sick and dying obtain the compensation they deserve, but also to protect the other victims of asbestos litigation – shareholders, employees, and communities that are injured when companies are made the targets of thousands of frivolous lawsuits.

Lifting this burden from the neck of American business would contribute enormously to economic recovery. Without the asbestos albatross, the thousands of affected firms would be more likely to increase profits, expand their business, make capital investments and create jobs. Reform is also likely to stop the flood of asbestos bankruptcies. These impacts would almost certainly increase federal tax revenues, reduce unemployment claims and help resolve the country's budget problems.

Let me turn now more broadly to the state of the economy, and more specifically, to the state of the manufacturing economy. On these issues, I speak not for the Alliance, but on behalf of the National Association of Manufacturers. NAM is the nation's largest industrial trade association and represents 14,000 members, including 10,000 small- and mid-sized companies.

The recent economic downturn hit manufactures much harder than the rest of the economy both in terms of depth and duration. Manufacturers began slipping into recession in the third quarter of 2000 – well ahead of the rest of the economy. And by the time that manufacturing output began to turn up in the beginning of 2002, industrial output had fallen by 8 percent over the previous 18 months. This is much worse than the rest of the economy. Overall, GDP slipped less than half a percent during the first three quarters of 2001 – the second-mildest recession in 50 years.

And while the overall economy grew a modest 3 percent last year, manufacturing output edged up only 1.7 percent[1]. This manufacturing "recovery" is slower than the first year of any recovery over the past 40 years and less than one-fifth the average 10 percent growth during the initial 12 months of the past six expansions.

[1] NAM GDP estimate based on published data through the third quarter and a fourth quarter projection.

Since July 2000, manufacturing employment has fallen by 2 million over the course of 29 consecutive monthly declines. By contrast, the employment in the rest of the economy has grown by 954,000, with a brief, but sharp drop in employment immediately following September 11th sandwiched between months of modest employment growth.

During the manufacturing downturn that began in June 2000 and ended 18 months later in December 2001, 1.4 million manufacturing jobs were lost. This 8 percent decline in manufacturing employment rolls matches the average decline during the past six recessions. However, for 2002 overall, another 592,000 manufacturing jobs were lost. This stands in stark contrast to the average 352,000 increase in manufacturing employment that typically has taken place during the first year of previous expansions and clearly shows that the recovery has largely bypassed the manufacturing sector, which was hit hardest in 2001.

To date, the largest employment declines by far have taken place in the electronics and industrial equipment industries. Each has lost more than 350,000 jobs and together account for more than a third of the manufacturing job losses since mid-2000.

The reason why manufacturing was hit much harder than the rest of the economy in the recession and why the recovery has evaded manufacturers is that the recession was mainly caused by a collapse of business investment and exports, which declined by 9 percent and 11 percent respectively in 2001[2]. By contrast consumer spending held up reasonably well, growing by 2.8 percent in 2001.

[2] Q4/Q4 percent change.

More recently, the 2002 recovery was largely driven by consumer spending, which accelerated modestly to 3 percent growth last year.[1] At the same time, business investment spending continued to decline by 3 percent, while goods exports edged up just 2 percent (remaining 8 percent below their level two years ago). This stands in stark contrast to 10 percent growth in exports during the first year of recovery following the 1990-91 recession.

Weak business investment demand and export growth have constrained the recovery for manufacturers, the producers of capital goods used by American industry and the source of two-thirds of overall exports. In short, the expansion to-date has been narrow, unbalanced and historically sluggish.

Despite historically low interest rates, and a bonus depreciation stimulus package passed last year, significant inhibitors to economic growth remain. Some of the challenges facing manufacturers are long-term problems that need to be addressed to create a better environment for manufacturing in America.

- Manufacturers are competing in a deflationary environment, with pricing power *falling* at an average annual rate of 0.9 percent since 1995. By contrast, the inflation rate for the economy overall has averaged 2 percent since the mid 1990s.

- At the same time, heavy regulatory and legal costs are undercutting business competitiveness. Combined, a heavy regulatory and legal burden cost U.S. firms $697 billion, or 6.7 percent of GDP, in 2002.[3] Manufacturers are especially hard hit. The cost of regulatory compliance alone adds up to $8,000 per manufacturing employee. This is 67 percent higher than the average cost to business overall.

- Manufacturers' healthcare costs rose at an average rate of 13 percent over the past year.

- 80 percent of NAM's membership found a moderate to serious shortage of qualified applicants in 2001. This signals that a persistent skills gap remains a problem for manufacturers.

- U.S. share of world manufactured exports has fallen from 13 to 11 percent since 1997 due to the rise in the value of the dollar. And while the dollar has fallen since its peak last February, it still remains 15 percent above its historic level.

Businesses have also become increasingly uncertain about the short term outlook, evidenced by the fact that the ISM business activity index dropped 9 percent from May to December 2002. This lack of confidence has curtailed investment spending, which is the main reason why the current recovery has underperformed past recoveries.

Businesses confidence has been undercut since the final quarter of the 2001 recession for a number of reasons.

[3] NAM estimate based on reports by the Council of Economic Advisors and the Small Business Administration

- First, the attacks of September 11 and the entry of our nation into a war on terrorism have created an elevated degree of uncertainty in the nation overall.

- Second, the emergence of several major financial scandals in 2002 undercut consumer confidence and sent the Dow Jones Industrial Average plummeting 32 percent between March and October 2002. As a result, consumer confidence fell to a 9-year low by October 2002. So, despite healthy growth in real incomes throughout 2002, consumer uneasiness deepened. This dichotomy has caused businesses to put on hold their spending plans for the fear that expected demand may not materialize.

- Third, the probability of a war in the Middle East, and its possible effects on world oil supplies and prices, has further elevated both business and consumer uncertainty.

At the same time, some important fundamentals of the economy have improved and have primed the economy for faster growth once uncertainty dissipates.

- First, there has been a steady and strong acceleration in productivity and associated gains in real incomes in 2002. By the third quarter of 2002, business productivity growth was 5.6 percent higher than a year earlier – the fastest quarterly growth rate in 36 years. This increase in productivity has, in turn, increased real wages. During the first three quarters of 2002, real disposable income grew 3.9 percent over the previous year. This is more than double the modest 1.8 percent growth in 2001 and is a solid foundation for consumer spending going forward once confidence improves.

- Second, this rise in productivity has rapidly pushed down unit labor costs, which has, in turn, led to a recovery in profits. In fact, for the first time since 1949, the labor cost per unit of output has declined four quarters in a row beginning in the 4th quarter of 2001.

  As a result, corporate profits have begun to make a recovery. Manufacturing profits declined by $75 billion from the third quarter of 2000 to the first quarter of 2001. By the third quarter of 2002, nearly two-thirds of this decline was recovered. Similarly, after dropping $138 billion between the fourth quarter of 1999 and the third quarter of 2001, overall corporate profits have rebounded 60 percent.

  This recovery in business profits should prop up business investment spending and counter some of the general uncertainty that continues to exist in corporate America.

- Third, though it still remains 14 percent above its 1997 value, the dollar has depreciated 9 percent since February 2002. This, combined with slightly faster expected economic growth abroad in 2003, should prop up an export recovery which, to date, has been very modest. However, further depreciation is needed for manufacturers to regain their international competitiveness.

- Fourth, after inventory levels reached a five-year high in mid-2001, manufacturers aggressively worked off excess stocks over the past year. Manufacturers' inventory-tosales ratios are now near a decade low. This means that firms will respond to stronger demand with increased production since inventory stocks are lean.

Increased uncertainty and an improvement in the fundamentals will work at cross purposes in 2003. While real income growth should keep consumer spending on track, this could be derailed by further shocks to confidence. As a result, businesses will continue to hold back spending plans. Therefore, an acceleration in the economic recovery will not likely take place this year without significant fiscal stimulus to counter the threat of uncertainty. This has important ramifications to the manufacturing sector. Without a meaningful pickup in business investment spending, an upturn in the manufacturing recovery will continue on hold.

NAM strongly supports President Bush's economic growth plan because it offers a creative mix of incentives that will encourage aggressive investment in the stock market and new capital investment by business, which will create more jobs. Specifically, the proposal to eliminate double-taxation of dividends will boost business and consumer confidence, reduce the cost of investment capital and encourage business to invest more in new plants and equipment.

Small business will especially benefit by the proposal to increase the allowance for expensing capital investments from $25,000 to $75,000, indexed to inflation. This will provide a powerful incentive for small manufacturers to increase investment and create jobs.

NAM also endorses the President's support of regulatory and legal reforms as a critical key to stimulating the economy and creating jobs. Removing unnecessary impediments to growth is as important as providing economic incentives.

Thank you, Mr. Chairman. I will be glad to answer any questions you might have.

The NAM's Pro-Manufacturing Agenda for 2003

American manufacturing is innovative, productive and efficient. For decades it has been the center of the strength of the American economy and its prospects for future growth. With the best workers in the world, technologies that are on the global cutting edge and R&D efforts capable of keeping it there, manufacturing in America made this country the world's high-quality, low-cost leader in a wide variety of products and made the U.S. the largest goods exporter in a world marked by the most intense global competition in history.

Yet currently manufacturing is at a crossroads -- it lags the rest of the U.S. economy and its recovery from recession is slow. The recession itself, unlike all previous post WWII downturns, uniquely affected manufacturing and caused the loss of two million manufacturing jobs. There are many reasons for this including geopolitical uncertainties, the ongoing war on terrorism and slow economic growth worldwide.

In addition to global uncertainty, however, there are factors contributing to the manufacturing slowdown that require policymakers' attention and which, if appropriately addressed, can do much to reinvigorate manufacturing, stimulate more robust and durable growth and increase employment:

- American manufacturing is at a distinct disadvantage in global competition due to unfair trade practices, export constraints and artificially distorted currency values, such as in China where the currency is undervalued as much as 40 percent.
- Intense foreign and domestic competition makes it impossible for American manufacturers to raise prices for their products, fatally compromising their ability to meet rising costs associated with government regulations, runaway litigation and employee health insurance.
- Accelerating technological change could make it increasingly difficult to achieve high productivity growth because of inadequate capital investment and workforce skill deficiencies.

To deal with these issues, strengthen the economy and encourage growth, the NAM will pursue the following policy agenda in 2003:

Taxes: To encourage capital investment, productivity and job creation, there should be further acceleration of depreciation and reduced taxation of dividends. The tax relief enacted in 2001, including estate tax repeal, should be made permanent and the scheduled marginal rate cuts accelerated. The ongoing impasse with the European Union over the World Trade Organization ruling on taxation of extraterritorial income (the FSC/ETI case) must also be addressed, and further reforms in the international tax arena should be enacted to enable U.S. companies to effectively compete in the global marketplace. We also need a permanent R&D tax credit that benefits the largest number of companies and pension reforms to encourage greater participation in the private retirement system. Finally, to ensure that these tax law changes benefit all manufacturers, action is needed to repeal the corporate alternative minimum tax (AMT), the "anti-manufacturing tax."

Trade: Changing global competitive conditions must be a priority. The U.S. must insist that foreign markets become open and trade must follow global rules. The U.S. should advance the WTO Doha Round, including the “zero-tariffs” proposal, a Free Trade Agreement of the Americas Agreement and additional bilateral trade agreements. U.S. policy governing export controls and unilateral sanctions must be modernized and an exchange rate regime should be promoted that is based on economic fundamentals and the free operation of markets. Given the rapidly rising importance of China in world trade, the Bush Administration should seek a particular commitment from China to the market valuation of its currency.

Training and Skills: Jobs in American manufacturing are among the best jobs in the world. They are rewarding; they are also increasingly demanding of skills. Both the workers of today, and tomorrow’s workers now in school, need improved systems of education and training through stronger implementation of the Workforce Investment Act, improved vocational education and a strengthened, reauthorized Higher Education Act.

Technology: Most R&D is in manufacturing, our key technological and economic advantage. We can preserve and enhance it with improved tax treatment of R&D expenditures, stronger protection for intellectual property in a globally competitive environment, adequate funding of federal science programs and a strong patent system.

Reform of the Health Care System: Increased federal mandates and liability exposure for employers will raise costs and reduce insurance for workers. Policy-makers should focus on lowering costs through improved quality and greater access to health care for all Americans, and work to reform Medicare in a way that allows addition of a prescription drug benefit to a strengthened program. Reform of medical liability law must also be a priority.

Asbestos Litigation Reform: The current system is dysfunctional, compensating people who are not sick at the expense of people who are, bankrupting companies in the process and threatening jobs and retirement savings of hundreds of thousands of manufacturing workers. Medical criteria legislation, like that advanced by the NAM’s Asbestos Alliance, is urgently needed.

Reform of the Legal System: A durable priority for manufacturers, reform of the legal system can be advanced in the 108th Congress. Prospects for class action reform and medical malpractice legislation, among others, can be furthered by widespread manufacturing participation in the NAM’s FLAG program (the Fair Litigation Action Group) designed to enable member companies to inform and enlist their workers in the effort to hold members of Congress accountable for enacting needed reforms.

Energy Policy: Enactment of a balanced, comprehensive, national energy policy is overdue and is essential to ensuring durable and sustainable economic growth in manufacturing and the broader economy. Reliable supply at affordable prices, increased efficiency, strengthened infrastructure and investments in R&D and new technologies
are each essential elements of sound policy. Recognition of the mutual benefits to all three partners of greater cooperation in a NAFTA energy alliance holds much promise. The NAM supports the President’s climate research and voluntary greenhouse gas reduction initiatives, but

opposes mandatory greenhouse gas reporting. The NAM vigorously opposes the Kyoto Protocol and any domestic actions leading to quotas or caps on fossil energy use by utilities or by industry.

Environment: The U.S. must continue making environmental progress while maintaining economic growth in the competitive world marketplace. To achieve these dual goals, environmental policy must continue to evolve from decades-old command-and-control prescriptions to approaches that encourage innovation, investments and partnerships. When environmental regulation is necessary, rules must be based on sound science and accurate data, and allow maximum flexibility to meet performance standards by using the most cost-effective means. Specific priorities for the manufacturing community this year include New Source Review (NSR) reform, sensible multi-emissions legislation and science-based air quality standards.

Transportation: Just-in-time operations are a vital component of modern manufacturing. Just-in-time is based upon a reliable and satisfactory transportation infrastructure. The NAM supports adequate investment in our transportation infrastructure, especially the need for improved intermodal connectors and facilities as well as other improvements to make freight travel more timely and efficient.

1/23/03