

Identifying the Challenges Facing American Manufacturing

This chapter highlights the challenges facing the U.S. manufacturing sector, as expressed by manufacturers themselves through the Department of Commerce roundtables. It also seeks to capture the priority issues that manufacturers believe need to be addressed in a comprehensive strategy to ensure the competitiveness of U.S. manufacturing. The views reflect a common understanding of the trends outlined in Chapter 1 that likely will shape the competitive environment for manufacturing. Manufacturers also recognized the basic strengths of the U.S. manufacturing sector as it meets the challenge of competing in a global economy.

If there was one underlying theme that emerged in the roundtables, it was the understanding that fundamental adjustments are under way throughout the global manufacturing sector. Manufacturers asked for an increasing focus by government on these adjustments and wanted to ensure that government was taking the steps necessary to create an economic environment in which U.S. manufacturers could succeed.

Toward that end, manufacturers attending the Commerce Department's roundtables outlined six areas that require immediate attention:

1. Manufacturers perceived a lack of focus within government on manufacturing and its competitiveness. Manufacturers are looking for a commitment to understanding the challenges that the sector faces in competing in a rapidly globalizing economy. They want government to take the steps needed to foster the manufacturing sector's ability to adjust to that new competitive reality.

2. Manufacturers want the government to focus on encouraging stronger economic growth both at home and abroad. There is a broad understanding that the recent recession was led by a sharp drop in business investment and that both monetary policy and fiscal policy have worked to set the economy on the route to recovery. But there are still steps that manufacturers feel are necessary to encourage business investment, and to reinforce the recovery under way in the economy as a whole and in the manufacturing sector in particular.

3. Manufacturers see the need for government to match the effort that they have made in controlling manufacturing costs. As manufacturers have focused on reducing costs to improve productivity and ensure their competitiveness, they often find their efforts eroded by costs they cannot control—costs that result in

part from government policy. Manufacturers seek a commitment on the part of government to reduce those costs and, in the process, create an economic environment that is attractive to investment in manufacturing within the United States.

4. Manufacturers emphasized that enhancing America's technological leadership was critical to their future. There is widespread recognition that the United States remains the world's leader for investment in research and development, and that U.S. investments in technology have paid significant dividends in current manufacturing competitiveness. It is also understood by U.S. manufacturers that technology is now more widely diffused throughout the world economy and that this trend risks eroding what has become the principal competitive advantage of the United States. What manufacturers seek is a commitment to encourage research and development and to ensure that the government reinforces, rather than creates obstacles to, the process of bringing innovations to the marketplace.

5. Manufacturers regarded education as crucial. Manufacturers are extremely interested in addressing the shortcomings of the U.S. educational system. Roundtable participants underscored that the evolving nature of the manufacturing sector relies on individuals entering the workforce with greater problem-solving abilities. These workers must continually sharpen their skills through lifelong learning. In addition, roundtable participants expressed concern that the United States risks losing an innovation infrastructure if the nation fails to produce scientists and engineers. Manufacturers seek a renewed emphasis from all levels of government to invest in educational and training institutions.

6. Manufacturers also focused on the need for international trade and monetary policies that ensure that global competition in manufacturing is free, open, and

fair. Many manufacturers expressed concerns regarding China. What manufacturers seek is not protection from competition, but the ability to compete on equal terms. Toward that end, they strongly support leveling the playing field internationally by lowering barriers to trade and eliminating efforts by foreign governments to confer unfair competitive advantages for their manufacturers.

The following discussion explores each of those themes.

Focusing on Manufacturing and Its Competitiveness

At every roundtable, U.S. manufacturers made the point that, although the manufacturing sector represents a cornerstone of the U.S. economy, manufacturing receives scant attention from the public or government. To many manufacturers across the country, it appears that the public and government have lost sight of a simple truth: you cannot have good jobs if you do not have strong businesses.

That thought was articulated by Phyllis Eisen of the National Association of Manufacturers at a roundtable held in Washington, D.C. She summed up her conversations with "teachers, educators at all levels, with kids from seventh grade through university, with their parents, with politicians, and with our own manufacturers," with this statement:

The information we got is not good about manufacturing. It is invisible to most people. They don't equate the table and the spoon they use and the glass they use . . . with this extraordinary industrial strength that we've had for so many years and that we have to maintain.

Some roundtable participants went further, describing what they saw as a pervasive bias against manufacturing, based on an old assembly-line image, causing the best and the brightest to pursue careers outside the manufacturing sector. At the roundtable in New Britain, Conn.,

Bruce Thompson of Projects Incorporated noted that manufacturing had evolved in ways most people did not know or appreciate. He emphasized that “people need to get out and see that it’s not a dirty, oily, old mess anymore. It’s technicians running high-precision equipment.”

The roundtable participants attributed some of the public’s misperception about manufacturing to the lack of focus in government on manufacturing. They pointed out that there was no single advocate for manufacturing within the executive branch departments. “I think the United States is the only country in the G8 which doesn’t have a very-high level department of manufacturing,” said Bob Brunner of Illinois Tool Works at the Rockford, Ill., roundtable. “I think that [establishing such a department] would be a real positive development in terms of supporting us manufacturers.”

Manufacturers expressed frustration that there was no focal point for the many programs that government supports at the federal, state, and local levels to assist manufacturers. Bruce Thompson pointed out that there was no “seamless interface.” What was needed, in his view, was “a one-stop shopping mentality,” so that manufacturers do not have to call on a lot of different organizations to get the information and assistance that they need. As Von Hatley of the Louisiana Department of Economic Development put it at a roundtable in New Orleans, “We really need a concerted effort between federal and state [governments] to do what it takes to save manufacturing.” To ensure accountability, manufacturers sought the establishment of a single office within government with responsibility for implementing the Manufacturing Initiative.

Historically there has been little institutional focus on manufacturing in the federal government. Although various agencies take into account elements of manufacturing competitiveness, in practice there is no mechanism to coordinate these

efforts. While it is widely understood that the Commerce Department serves as the principal advocate for manufacturing’s interests, there is no office in the Commerce Department that is solely responsible for looking out for the competitiveness of U.S. manufacturing.

Many roundtable participants thus requested the establishment of a manufacturing-related position within the Commerce Department at the assistant secretary level or higher to focus on manufacturing competitiveness and the health of the manufacturing sector in general. Manufacturers also urged stronger coordination both within the federal government and with state and local governments to foster investment in manufacturing, as well as requesting a regular dialogue between government and the manufacturing sector on its competitive challenges.

The administration has therefore proposed creating an assistant secretary for manufacturing and services who would develop and implement a comprehensive strategy on manufacturing. While maintaining a focus on manufacturing, strategic planning must include the service sector, which both influences and benefits from the manufacturing sector’s competitiveness.

This new position would provide the focus within the Commerce Department needed to respond to manufacturers’ concerns. The assistant secretary’s office would be able to provide regulatory economic analysis essential to assessing the costs and benefits of government action on manufacturing competitiveness. This office would be charged with establishing a mechanism for coordinating manufacturing-related initiatives among the various executive branch agencies and would

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enhance the Commerce Department's ability to ensure that focus on a government-wide basis.

The Need for Stronger Economic Growth at Home and Abroad

Manufacturers attending the roundtables indicated that the single most important economic policy objective from their perspective was encouraging economic growth. Stewart Dahlberg of J.D. Street & Co. described the reality of the global marketplace at the St. Louis, Mo., roundtable:

The world is a very big place. There are lots of customers out there and lots of niche customers to find. What we would . . . simply ask [is] that every possible opportunity to open up every single possible market be investigated and called out anywhere you can.

Although many of the specific concerns raised by manufacturers focused on the effect of indirect costs on the supply side of the economic equation, no one disagreed with the notion that the first and most pressing issue was sufficient demand, domestically and globally, to stimulate purchases by consumers and businesses of the goods that U.S. manufacturers produce.

Manufacturers recognized that the most recent recession was one driven by a sharp decline in business investment, rather than a drop in consumer spending. They also understood that policies designed to encourage business investment were essential to any recovery in manufacturing. Most manufacturers indicated that recent efforts to stimulate the economy were paying off, even though they had not fully filtered through to the manufacturing sector. As Mustafa Mohatarem of General Motors put it at the roundtable in Washington, D.C., the recent passage of the Jobs and Growth Tax

Relief Reconciliation Act was a "significant achievement," and the resulting recovery in the U.S. economy would "create sufficient or significant demand for investment in the industry" to put the manufacturing sector on the right path.

Despite the reductions in capital gains and dividend taxes, as well as expensing provisions, many manufacturers believed that the recent tax cuts did not go far enough. They underscored the need to create greater certainty under the tax code to encourage business investment. They also emphasized their desire for government to address longer-term issues: specifically, manufacturers highlighted the need to reform the tax code to eliminate the penalties they believe it imposes on their businesses, such as outmoded depreciation schedules and the overall impact of the alternative minimum tax.

They also sought simplification of the tax code, which in its present complexity raises the costs of compliance—particularly for smaller manufacturers. Manufacturers further focused on reforms in the tax code that they believe would yield a broader and deeper pool of investment capital to the benefit of U.S. manufacturers, particularly for small and medium-sized businesses. Murry Gerber, former chair of NAM's Small and Medium Manufacturers Group, explained the need at the New Britain, Conn., roundtable:

They [small and medium-sized manufacturers] haven't kept up to date with new equipment, and you can't blame them. They have had falling sales, their margins are decimated, they don't have the wherewithal. . . . An offer of investment tax credits . . . would drive companies to put on this additional equipment that's consistent with the high-tech manufacturing in the future.

There is little doubt that reducing complexity and making the recent tax

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cuts permanent would encourage business investment. Greater certainty as to the tax treatment of earnings is one of the basic components in any firm's investment plans.

The other salient point reflected in the comments of manufacturers was a clear understanding of the implications of slower growth abroad. Roundtable participants focused on the need to use both international monetary and trade policy to promote growth internationally. They cited issues such as exchange rates, based on their understanding of the economics affecting the value of the dollar. They made the point that, in addition to doing everything possible to restore growth at home, the United States needs to press its major trading partners for stronger growth abroad.

Encouraging international economic growth requires consistent advocacy of growth-oriented economic policies abroad. Not only must the United States promote growth through its own economic policies, but it also must be willing to "preach what it practices."

In practical terms for policy-makers, promoting economic growth abroad means action on two fronts. The first is focusing discussions with U.S. trading partners, whether bilaterally or multilaterally, on policies that will foster growth. That means continuing to advocate growth in G7 finance ministers' meetings, the G8 summit, and the annual meetings of the International Monetary Fund and the World Bank, since growth is not an issue for the larger, industrial economies alone. But it also means, most particularly, encouraging the largest economies in the world to pursue policies that stimulate their growth, since they make up a significant share of the world economy.

Growth-oriented economic policies start with the basics, such as promoting respect for private property and observance of the rule of law, which are essential to all market transactions. It means ensuring

monetary stability, reducing taxes, and reducing the costs and inflexibility of heavy regulations that impose limits on growth. Every country, including the United States, has room for improvement in terms of the steps it could take to foster growth and a rising standard of living.

Another aspect of growth involves trade liberalization. From the perspective of U.S. manufacturing, reducing trade barriers and opening markets abroad has manifold advantages. Liberalization promotes economic growth in foreign markets, which raises the demand for manufactured goods worldwide. It offers the prospect of higher exports, and the resulting greater efficiencies for American manufacturers and exporters. It also eliminates the implicit subsidy that tariff protection extends to foreign competitors.

Significantly, U.S. manufacturers continue to stand behind the effort to open markets abroad at the negotiating table. That is true of virtually every industry and business large and small. Matthew Coffey, of the National Tooling and Machining Association, which represents many small and medium-sized metalworking firms across the United States, put it this way in an NTMA policy paper:

The NTMA believes in the free-enterprise system . . . whether it is in the United States, the Americas, or the world as a whole. That leads us to the conclusion that competition should be open. The NTMA is in favor of open markets and getting rid of trade barriers and tariffs and has, therefore, generally supported free trade initiatives as long as there was a prospect of fairness over time.¹

In short, American manufacturers, both large and small, understand the value of promoting economic growth worldwide and reducing the barriers to global trade. They are more than willing to compete in that environment as long as the competition is open and fair, and as long as the same rules governing competition apply equally to all.

Reducing the Costs That Erode Competitiveness

One of the most consistent themes expressed by manufacturers attending the roundtables was the need to “keep our side of the street clean.” For manufacturers mean that government, at all levels, must understand that it does not have the luxury of making domestic economic policy choices in a vacuum. Every regulation, every additional form to be filed, every increase in litigation, and every increase in healthcare costs can impose unwarranted costs on American manufacturing.

Manufacturers expressed concern that, too often, fundamental decisions about taxation, government spending, environmental regulation, workplace reforms, energy policy, personal injury compensation, and trade policy are made in isolation. They stated that legislatures, administrative agencies, and courts make decisions without understanding the multiple burdens that those decisions impose on manufacturers.

Rising Healthcare Costs

Curt Magleby of the Ford Motor Company underscored this most frequently cited concern at a roundtable in Washington, D.C.: “Where we really need help for U.S. manufacturing is some stability in healthcare.” Most manufacturers indicated that they want to continue to provide healthcare benefits, because such benefits made for a motivated and more productive workforce that contributed to the success of their firms.

Rapidly increasing healthcare costs directly affect the bottom lines of U.S. manufacturers and steadily erode their competitiveness. John Vaught of Tri-Cast noted at the Columbus, Ohio, roundtable that, while the cost of the healthcare he provides to his employees had been “skyrocketing,” he was only able to raise prices less than 1 percent a year.

Keith Guggenberger of Starkey Labs summed up the perspective of many U.S. manufacturers, at the roundtable in Minneapolis, Minn.:

Healthcare is a big part of the concerns of policy that we have in keeping us competitive. . . . At Starkey, we spend almost \$8,000 per employee on healthcare in the U.S., and when half of our people make under \$28,000 a year, it is hard to make those sorts of ends meet.

The problem is becoming particularly acute in the automotive industry, which is central to the health of so many other manufacturers, particularly in the Midwest. At a Washington, D.C., roundtable, Mustafa Mohatarem of General Motors underscored that point:

American companies also face two other challenges that are related to their legacy costs. The first is pensions, which over time is most likely to be equalized. That's something we have negotiated and we're trying to address within that context. The one we don't have as good of control on is the medical side of it. As you know, the cost of medical care has been rising much more rapidly than other costs in our economy. So the traditional American companies that have large healthcare obligations to retirees are being really harmed by this rapid increase in healthcare costs.

This statement is not merely anecdotal: there is no doubt that healthcare costs have risen sharply. A 2002 report by PricewaterhouseCoopers noted that in 2000, the share of U.S. GDP devoted to healthcare was 13.2 percent, up from 8.8 percent in 1980, and, according to forecasts, that share will continue to rise and reach 16 percent of GDP during the next five years.²

The rising cost of healthcare is the biggest barrier to health coverage. The annual family health insurance premium increased to \$9,068 in spring 2003, according to a survey of 2,808 companies by the Kaiser Family Foundation and the Health Research and Educational Trust.³ Further,

between spring 2002 and spring 2003, monthly premiums for employer-sponsored health insurance rose 13.9 percent—the third consecutive year of double-digit premium increases and the highest premium increase since 1990. Small firms, with three to nine workers, faced the largest increase of all: a 16.6-percent surge in premiums.⁴

Rising healthcare costs are not unique to the United States. While overall spending on healthcare is higher in the United States, the growth rate of spending is similar to that of other nations. The average real annual rise in healthcare spending in this country was 3.2 percent from 1990 through 2000, which is comparable to the 3.3-percent rate in OECD countries, and the 3.1-percent growth rate among countries in the European Union.⁵

However, what is unique to the United States is the extent to which it relies on businesses as the primary providers of healthcare coverage and the burdens they bear as a consequence.⁶ Employer-sponsored health insurance is a cornerstone of healthcare financing in the United States. Three out of every five Americans receive some type of employer-sponsored health benefits.⁷

According to the National Association of Manufacturers, 97 percent of its members continue to voluntarily support employer-provided healthcare in spite of the growing cost of these benefits and the sluggish economy for manufacturing.⁸ The percentage of employers providing coverage has not declined substantially, and in spite of rising costs, employers have not increased the percentage of the premium paid by the employee.

To avoid shifting more of the costs to the actual consumers of healthcare services, employers, particularly those in small and medium-sized manufacturing firms, have to find ways to contain costs or they

become less competitive. However, cost containment may not be an avenue open to small manufacturers, which face special problems in obtaining health insurance. They commonly must pay higher premiums and, thus, are less likely to offer health insurance as a benefit.

Employers, both large and small, have responded to these rising costs in a variety of ways. Firms are less likely to offer retiree health coverage; the percentage of large firms offering retiree health

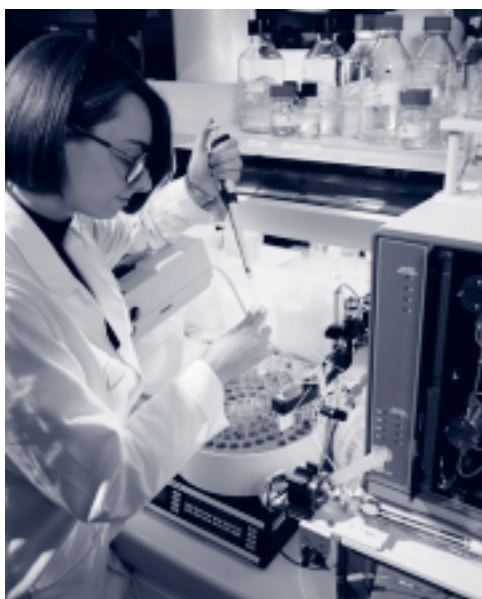


Commerce Secretary Donald Evans, Labor Secretary Elaine Chao, and Treasury Secretary John Snow discuss U.S. manufacturing with factory workers at Harley Davidson headquarters in Milwaukee, Wisconsin.

benefits has decreased from 66 percent in 1988 to 38 percent today.⁹ And many firms increasingly rely on cost sharing as a way to increase awareness of cost and value in healthcare. Tiered reimbursements, often used for drug benefits, have become a common approach to encouraging the use of generic and lower-priced medications. Some companies have begun offering consumer-driven health plans, which combine high-deductible insurance with health spending accounts.

What these facts suggest regarding policy is that there is economic and competitive value for reducing the growth in healthcare costs that U.S. manufacturing companies face, particularly for the small and medium-sized manufacturers that are the foundation of the U.S. manufacturing

sector. One means of addressing their needs, as well as those of larger firms, would be to encourage the development of association health plans and other joint purchasing arrangements that would increase firms' bargaining power in the market for health insurance and healthcare services.



The historic Medicare reform legislation, which was enacted following the roundtables, provides assistance to firms offering health insurance to retirees and is an important step in controlling healthcare costs. This legislation also established health savings accounts to help employees pay for their healthcare expenses by combining the purchase of a high-deductible health insurance plan with tax-free savings accounts. Employees will use the accounts to pay for their healthcare needs, with any remaining balances rolled over from year to year. HSAs ensure that workers have the health insurance coverage they need plus the money to pay for day-to-day medical care, all while providing them with an incentive to save for their future health care needs.

Addressing the underlying causes of rising healthcare costs would, of course, complement the effort to improve cost containment. In that regard, tort reform, discussed below, is vital. Current malpractice litigation often fails to compensate people who should be compensated and rewards those who do not experience malpractice. In the process, it also dramatically raises the costs of all doctors and healthcare providers, regardless of their records, by increasing liability insurance premiums. Equally important, it raises the cost to the consumer and to the employer in manufacturing by encouraging costly and wasteful "defensive" medicine.

Need for Tort Reform

Perhaps no single issue drew more heated comments from manufacturers than the need for tort reform. Manufacturers pointed to a system that drove insurance costs higher even for firms that had never had lawsuits filed against them or had never put hazardous products on the market. Rick Kelly of Pellerin Milnor Corp. explained at a roundtable in New Orleans, La., that his firm had recently renewed his product liability insurance and was obliged to pay an annual premium worth 30 percent of the coverage itself. As Kelly put it:

We need tort reform real bad. We just recently had our insurance renewed for the following year. A \$1-million product liability insurance premium gives you \$3 million in coverage. That's insane. That's absolutely insane.

These comments only begin to describe the ways that tort costs debilitate businesses. Manufacturing firms pay "tort taxes" in several ways. First, manufacturers pay significantly higher costs for employee healthcare benefits, due to increasing medical liability costs. Second, manufacturers pay as product liability and other tort claims increase the cost of general liability insurance. And third, manufacturers pay in the form of legal fees even

when there is no merit to claims and manufacturers ultimately prevail in litigation—a problem that is only exacerbated by the growth of frivolous shareholder class-action suits.

The indirect costs of tort litigation are also significant—particularly the time spent by managers and employees, who would otherwise focus on improving operations, raising productivity, and expanding sales. Giff Kriebel of BAE Systems put that part of the tort system in perspective at the roundtable in Manchester, N.H. He said, “I can think of nothing that is more non-value-added than all the litigations that all of us have to go through. . . . The time it takes and distraction that it causes is absolutely huge.”

The basic reason for manufacturers’ concern about the civil liability system is the dramatic increase in tort claims and awards. Manufacturers have become outsized targets, as plaintiffs’ lawyers consider operating companies’ “deep pockets” of insurance and capital. From a personal injury lawyer’s perspective, manufacturers represent desirable defendants because juries can more easily sympathize with a claimant by assigning blame to a seemingly impersonal corporation regardless of fault, assumption of risk by the plaintiff, or contributory negligence.

The tort system significantly undermines the competitiveness of U.S. manufacturers. The awards have driven insurance premiums higher and, in instances when liability insurance proved cost prohibitive, the insurance premiums have driven firms out of business.

The examples of tort claims cited by manufacturers attending the Commerce Department’s roundtables were striking. In many instances, the connection between the plaintiff’s injury and the product put on the market by the defendant

manufacturer was dubious or nonexistent. From these types of tort claims, it is difficult to reach any conclusion other than that the company in question was targeted simply because the plaintiff’s counsel identified it as the deep pocket from which the lawyer could maximize the award.

Consumers, workers, and investors all pay for excessive claims of the current tort system. Tort costs amount to a tax on consumption, wages, and investment. Clearly, tort costs make U.S. manufacturers less competitive, increase the risk of bankruptcy, and are a significant drag on the American economy.

Just as important is the fact that the current system also fails to deliver for those who are injured and deserve compensation. Only 20 percent of direct tort costs actually go to claimants for economic damages, such as lost wages or medical expenses.¹⁰

The U.S. tort liability system is already the most expensive in the world; its cost is more than double the average cost of such systems in other industrial nations, as measured in GDP share. The consulting firm of Tillinghast-Towers Perrin published findings that in 2002, the U.S. tort system cost \$223 billion—approximately 2 percent of the nation’s GDP.¹¹ Similarly, the U.S. Chamber of Commerce recently released a study showing that a state’s tort liability system has a “statistically significant” impact on its economic development, which in plain terms means slower economic growth and fewer jobs, particularly in manufacturing.¹²

It is crucial to understand that none of these studies capture anything more than the direct outlays of existing firms, such as the payment of liability insurance premiums. Although those costs continue to rise dramatically, they understate the impact on manufacturers and the cost to

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the U.S. economy as a whole. These studies do not capture the value of the products that otherwise would have been developed or other opportunities that manufacturers have forgone because of litigation risk.

Manufacturers stated that common-sense legal reforms are crucial to bolstering manufacturing competitiveness. Although tort liability is most often a function of the common law of each state, a better balance needs to be struck. In fact, individual states are already developing models of tort reform in an effort to maintain their manufacturing bases.

Wisconsin's efforts at reform were touted at the Commerce Department's roundtable in Milwaukee as one of the reasons for manufacturing firms staying despite higher taxes and relatively broad regulation. As explained at the roundtable, the reforms in Wisconsin did no more than restore some of the balance that previously existed in U.S. tort law, as opposed to the strict liability standards enacted in many jurisdictions.

One particular issue on the legal front dwarfed all others: the ongoing asbestos litigation, which continues to create a great deal of uncertainty for manufacturers in the marketplace. The point raised by many manufacturers was hard to dispute. When asbestos was first installed as a safety device to retard the spread of fire in many factories, no one knew the potential danger of long-term exposure to asbestos. The product was not subject to regulation by the government, nor was there any warning to manufacturers regarding the risks inherent in its use.

But now, many years later, the multiple class-action lawsuits filed over the use of asbestos have created a legal and financial quagmire. While the litigation continues, affected individuals in American society are not receiving any assistance to cope with the medical bills they face. And the continuing litigation remains a cloud over the entire manufacturing sector.

The comments of Dow Chemical's Gene Reinhardt at a New Jersey roundtable put the problem in context:

Asbestos litigation that continues after so many years . . . is a problem for society in that . . . the victims of asbestos are not the ones getting the help. We'd like to see that we get some legislation that would protect the victims now and in the future and make the system fair. It is chaos now, with litigation coming from all directions that is damaging the economy and undermining the security of jobs and pension systems.

Tort reform should focus on three areas. The first is the critical need to cap medical malpractice awards in ways that ensure that those deserving compensation get compensated. The second is the need to restore the balance that previously existed in tort law: meaningful reforms are required that would hold individuals accountable for their own actions in the use of products, rather than holding manufacturers strictly liable for any injury suffered in proximity to their products. And the third area is the need to resolve the litigation over asbestos-related injuries by ensuring that those deserving compensation receive it. Such class-action suits remain a contingent liability for U.S. manufacturers, making it hard to attract capital and liability insurance for their current operations.

Reducing Regulatory Costs

At the roundtables, manufacturers frequently mentioned the issue of regulatory costs and the relative burdens they place on U.S. firms versus their competitors. An OMB study found that regulatory costs were 3.7 percent of GDP in 1997.¹³

Since manufacturing tends to bear a greater share of regulatory costs than other sectors, it is safe to assume that roughly 4 percent of manufacturing GDP goes to compliance. Of this, about half of

the cost is for compliance with environmental regulations; the remainder is for compliance with workplace safety and product safety requirements, as well as for the time spent filling out government paperwork and keeping records.

One measure of the economic cost of compliance is the cost to government of managing regulatory programs and the consequent drain on tax revenues which that effort represents. Total federal budget outlays for regulatory compliance activities have almost doubled in the past 13 years, from \$13.7 billion in 1990 to \$26.9 billion in 2003 in real terms.¹⁴ Those costs cover all regulatory activities, from trade and customs, to consumer safety, to securities laws. They do not include the cost to the private sector of compliance, which can be many times greater.

From a manufacturer's perspective, particularly that of a small or medium-sized business, the most common compliance costs are related to environmental regulation, workplace safety, and tax compliance/employment rules. The Small Business Administration's Office of Advocacy has conducted the most comprehensive study of those costs.¹⁵ The study found that the total cost of complying with regulations in those areas in 1997 amounted to \$147 billion annually, or a cost per employee of \$7,904. Of the individual categories that made up that total, environmental compliance costs took the largest share. Environmental costs accounted for nearly 50 percent of the total: \$69 billion in 1997, or a cost per employee of \$3,691.¹⁶

Significantly, the cost of compliance with such rules falls hardest on businesses with fewer than 20 employees. According to the SBA study, small manufacturing businesses reported that compliance with workplace rules amounted to a cost of \$16,920 per employee. For larger firms, that cost dropped by more than half, to \$7,454 per employee.¹⁷

Further, taken together, all compliance costs appear to have increased significantly since the SBA's study of 1997 data. According to a recent NAM study, the total burden of environmental, economic, workplace, and tax compliance is \$160 billion on manufacturers alone, equivalent to a 12-percent excise tax on manufacturing production. This reflects an increase of about 15 percent over the last five years.¹⁸ In short, regulatory compliance costs are rising faster than income in the manufacturing sector, which implies a loss of cost competitiveness or, at a minimum, a negative offset to the benefits of the extraordinary productivity gains and efforts by manufacturers to cut costs under their direct control.

Rising Energy Costs

Another point of concern for manufacturers is the rising cost of energy, particularly natural gas. Manufacturers depend on affordable, reliable energy. Industry uses more than one-third of all the energy consumed in the United States, the majority of which is natural gas and petroleum, followed by electricity. In all sectors, energy prices have a significant effect on operations and product prices.

Manufacturers uniformly criticized the failure to enact the legislative aspects of a comprehensive and coherent energy plan that would increase America's energy independence while yielding energy prices that would help ensure manufacturers' long-term competitiveness. Don Wainwright of Wainwright Industries put it in straightforward terms at a roundtable in St. Louis, Mo., explaining that manufacturing is "one of the biggest users of energy." He emphasized that, in his view, the biggest challenge facing his industry is "energy policy, which is before the Senate right now."

As it stands, America "faces the most serious energy shortage since the oil embargoes of the 1970s," directly attributable

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to a “fundamental imbalance between supply and demand.”¹⁹ From 1991 to 2000, Americans consumed 17 percent more energy than they had in the previous 10 years. During that same period, U.S. production rose only 4.9 percent; the difference accounted for by imports.²⁰

America’s energy challenge will continue to grow as the U.S. economy grows. Energy consumption in the United States is expected to rise “by about 32 percent by 2020.”²¹ While the Bush administration has pursued successful executive actions to increase domestic access and production, there is no prospect, in the absence of congressional action, for significant new U.S. production.

Conservation and efficiency can help, and U.S. manufacturers lead the way in producing and implementing technologies designed to foster efficiency and reduce costs. Those efforts pay big dividends. Today, it takes only 56 percent of the energy required to produce a dollar of GDP as it did in 1970. The nation’s “energy intensity” (the amount of energy required to produce a dollar of GDP) has declined in recent years and is expected to decline further, at a rate of 1.5 percent yearly, through 2020.²² With appropriate capital investments, conservation could reduce that figure even further. Yet in the short run, rising energy prices and disruptions in energy supply reduce profits, production, investment, and employment for U.S. businesses. In practical terms, absorbing the cost of high and rising energy prices means deteriorating profit margins. And by reducing a manufacturing company’s cash flow, high energy costs restrict a firm’s access to capital needed for new plants and equipment.

The impact of high energy costs on the demand side also negatively affects manufacturers. With rising energy costs taking a greater percentage of consumers’

budgets, consumer spending slows, lowering demand for manufactured goods. That contraction in demand feeds back into the manufacturing sector in the form of lower sales, lower use of capacity, and an inability to take advantage of the economies of scale that manufacturers’ existing capital investments would otherwise afford.

For energy-intensive industries such as paper products, plastics, and chemicals, the impact of rising energy costs, particularly the cost of natural gas, is compounded. At the Commerce Department’s roundtable in Trenton, N.J., Gene Reinhardt, of Dow Chemical Company, explained:

Those of us in the chemical sector are getting a double hit with natural gas, since we use it both for our fuel and as raw material for our chemicals. . . . Natural gas prices are the highest in the world and drain all of the industry. Consumers are spending \$70 billion more in natural gas costs in 2003 than they did last year in 2002. So it is not only an emergency or an emergent issue for Dow Chemical; it is really an issue for all of the industry in America.

Additionally, energy supply disruptions can pose a significant problem even in industries in which energy is not an important component of the total cost of the goods or services produced. Many businesses require a high-quality, reliable source of power. Even a brief loss of power can impose significant costs on technology firms. Products or product inputs may be damaged or destroyed, or production runs may be interrupted.

The effects of the blackouts in California several years ago illustrate this. A survey of small businesses, which was conducted by the National Federation of Independent Business in February 2001, found that more than half of the firms surveyed that had experienced blackouts in California were forced to reduce or shut down business operations altogether during the blackouts. About one-third of the firms surveyed lost sales. Roughly one-fifth

said materials were aged or destroyed. And nearly two-fifths absorbed additional costs, such as in wages and benefits, for work that was not completed.²³

Plainly, the problems manufacturers face because of rising energy costs and disruption have been a long time in the making. They are the product, like many of the other issues manufacturers raised during the roundtables, of nearly a decade of neglect. To put it in perspective, it helps to understand that not a “single major oil refinery has been built in the United States in nearly a generation.” By some estimates, the United States needs “38,000 miles of new gas pipelines, along with 250,000 miles of distribution lines” to match the demand for natural gas with supply.²⁴

It will take a comprehensive, long-term strategy to address the energy challenges facing America’s manufacturing sector, and an equal attention to modernizing the U.S. energy infrastructure, increasing energy supplies, and improving energy conservation and efficiency. And it will require a multifaceted approach. The nature of the problem requires first that government ensure that energy markets work well; for example, by moving ahead with the restructuring of electricity markets where necessary to ensure that energy savings are passed on to the consumer. The problem may also merit a hard look at increased federal funding for research and development of renewable energy resources and energy-saving manufacturing techniques and products, tax incentives for the development of new technologies, and greater coordination among the various levels of government involved in the approval and development of new energy supplies and infrastructure.

Taxes

Manufacturers pointed to federal, state, and local taxes as one of the key factors inhibiting future investment in

American manufacturing. Manufacturers attending the roundtables stressed the importance of cutting taxes in a way that would stimulate consumer demand and business investment, which has lagged even during the recovery from the recent recession.

The other frequently made point is the need for certainty. What manufacturers attending the roundtables see in the marketplace is an unwillingness of their



customers to make the investments that will lead to purchases of capital equipment and a strong recovery throughout the manufacturing sector. That unwillingness is inconsistent with the strong consumer demand that continues to pull the economy along through the recession and into a stronger recovery.

Manufacturers explained that the other forces inhibiting investment are related to the general uncertainty regarding the strength of the recovery, concerns regarding the effect of the events of September 11, 2001, the rising cost of security in their aftermath, and to the more uncertain international economic environment. However, the one concern manufacturers identified that is entirely within the control of

the federal government is the uncertainty created by frequent changes in the tax code and the often-conflicting policies that the tax code represents. U.S. manufacturers put a premium on getting the right rules and rates in place and then making them permanent so businesses can invest with greater certainty in terms of the treatment of income earned on their investments.

Interestingly, the most salient but least-understood tax issue involves the international provisions of the Internal Revenue Code. Far from encouraging companies to move offshore, manufacturers believe the IRC contains significant penalties on income derived from foreign investment that sometimes lead to the double taxation of foreign-source income. In a global economy, manufacturers under-

stand that their successes will increasingly depend on their ability either to export (which often requires investment abroad in marketing) or to sell to U.S. firms that compete in global markets (which also increasingly depends on the ability to invest, produce, source, and sell abroad).

In short, manufacturers recognize that the government should not impose penalties on those American companies that are the best U.S. competitors in world markets, even when the exact penalties imposed by the Internal Revenue Code are not always apparent to purely domestic producers.

The basic point in support of tax reform was made by Curt Magleby of Ford Motor Company at a roundtable in Washington, D.C.:

Our tax code internationally was developed in the 1940s and 1950s [and] updated in the 1980s and represented a completely different environment. For us to be competitive domestically, we've got to update the tax code on the international side.

In addition to the IRC's outdated international provisions, manufacturers

identified numerous ways in which the code may distort investment decisions. They cited the alternative minimum tax, which imposes significant extra costs on manufacturers and results in almost no additional revenue for the federal government. In addition, depreciation schedules in some sectors may not reflect high rates of innovation.

Assessing the full impact of the investment distortions contained in the current IRC requires an understanding of how the IRC's impact reaches well beyond the federal system of taxation. Because many state tax codes are ultimately based on definitions of income that flow from the federal tax code, the distortions of the IRC perpetuate themselves at the state level.

Several manufacturers went considerably further with respect to state and local taxation, suggesting changes to the most prevalent forms of state and local taxation. Many states and localities rely more heavily than the federal government on property and other taxes that are fixed in dollar amounts or in the form of a fixed percentage of asset value. Those taxes become far more regressive in an economic downturn; although revenues and income fall, the liability for tax does not. The net effect is an increase in tax on manufacturing firms as a percentage of income. The manufacturers' comments suggested a need to shift from taxes based on fixed values to those tied to income, and to rely more heavily on consumption as the basis for defining income subject to taxation.

Lastly, with respect to taxes, there is broad recognition of the advantage conferred on foreign manufacturers by the interrelationship between the current U.S. tax system and international trade rules. American manufacturers are well aware that most of their competitors are located in countries that rely more heavily on consumption, rather than income, as the basis for taxation. In practical terms, foreign governments apply taxes solely to income

manufacturers attending the roundtables stressed the importance of cutting taxes in a way that would stimulate consumer demand and business investment

earned on sales in their jurisdictions and will rebate any taxes that apply to exports.

By relying more heavily on income as the basis for taxation, and in taxing U.S. manufacturers on their worldwide income, the U.S. system contains no simple means of ensuring that U.S. exporters receive comparable treatment. The international trade rules reinforce that disparity because they allow the rebate of indirect taxes (that is, taxes on consumption such as value-added taxes) but prohibit the rebate of any direct taxes on income, on which the U.S. system relies so heavily. Although manufacturers believe recently passed changes in federal tax law have helped, manufacturers maintained that those changes do not go far enough to offset the underlying inequity between the tax treatment of most foreign manufactured goods and those produced in the United States.

The basic lesson to draw from the roundtables regarding tax is the need for both short- and long-term efforts to reduce the cost and uncertainty that the IRC creates for American manufacturers in their operations and their pursuit of investment capital needed to maintain their competitiveness. In the short term, the most significant step would be to make the recent tax cuts permanent in order to increase the certainty of the business environment in which manufacturers operate and the relative attractiveness of investing in manufacturing in the United States. In the long run, manufacturers called for an intense focus on tax reform—reform that reduces rates, reduces investment distortions, and simplifies the IRC to reduce the cost of compliance.

Reinforcing America's Technological Leadership

At every roundtable, American manufacturers expressed their concern for Amer-

ica's continued leadership in technology and its ability to produce the workforce needed to maintain U.S. excellence in manufacturing. Manufacturers continually emphasized the important role that technology plays in serving customers and ensuring cost competitiveness. Lou Auletta of Bauer, Inc., made that point at the New Britain, Conn., roundtable:

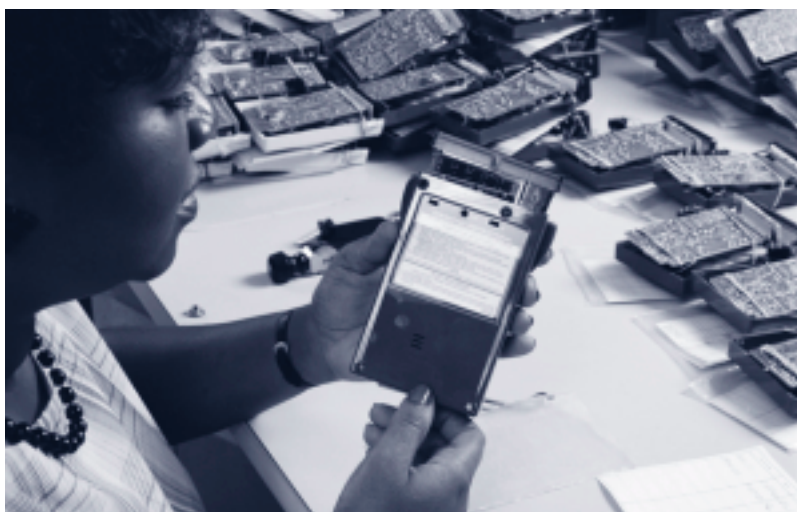
We're in the process of developing new technologies that are going to save our customers money, and also technologies and enhancements that are going to make us more efficient in production, both from the design aspect and the manufacturing side.

Manufacturers understand that leadership in innovation and technology are key to their future competitiveness. William Fee of Magnesium Elektron, Inc., at the Trenton, N.J., roundtable spoke for many in describing the process that his company had gone through to remain competitive, and the extent to which it increasingly depends on investment in technology:

Our response has been to shift our business towards more technically sophisticated applications, for example, catalysts, high-tech ceramics, and water treatment. To achieve competitive advantage in these new markets, we corner a strong commitment to research and development and ongoing innovation in products and the processes needed to manufacture them. To be successful, this strategy requires significant investment in scientific talent, laboratories and analytical equipment, intellectual property patents, and following the pursuit of same information technology to control manufacturing processes, and even the most difficult of all is step change in the level of detail engineering support necessary to manufacture products to ever-tightening specifications and consistency demanded by our customers.

From the perspective of manufacturers, there is a need for continuing investment in research and development of new products so that manufacturers remain one step ahead of the competition.

The fact that technology and innovation are key to the future of manufacturing simply reinforced the concern many manufacturers had for the declining investment in research and development as a percentage of GDP, both in industry and in government. Mike Mauer of Sikorsky Aircraft Group made that point at the roundtable in New Britain, Conn., noting that U.S. manufacturing's competitive edge depends on "great new technology . . . that's a result of some of the investments that were made 20, 30 years ago." Mauer described the decline in investment in research and development as "worrisome," recognizing that future



competitiveness is "really about the technology and the investment up front and . . . the engineering and development that ends up leading" manufacturing toward a more competitive future.

Many of the comments focused on making the Internal Revenue Code's research and experimentation credit permanent. At the roundtable in New Britain, Conn., Murry Gerber, former chair of NAM's Small and Medium Manufacturers Group, stated what was a uniform opinion among manufacturers:

One is the R&D tax credit, which should be made permanent. We've been arguing about

this for years and years, and it's critically important because if you want to know where manufacturing is going to be in 20 years; it's going to be involved with the highest-tech work that's possible in the world that can't be done in other nations where they pay 80 cents a day or whatever to lesser skilled workers.

As noted at the outset, U.S. manufacturers continue to invest in innovation and technology, accounting for the majority of R&D dollars spent in any given year. The roundtable participants also emphasized the importance of government's investment in the basic sciences that lead to later innovations in manufacturing. They view government's role as catalytic—sparking many of the ideas that manufacturers later transform into consumer products.

Manufacturers expressed concern over the declining commitment of federal government funds for directed basic or generic technology research of the sort that drives innovation in manufacturing. At the Washington, D.C., roundtable focused on the future of manufacturing, many of the attendees highlighted the well-known role that the Defense Department and the National Aeronautics and Space Administration played in research on electronics, computing, and communications. What manufacturers seek is focus within the government's budget on research that would yield the same spillover effects that the earlier work on defense applications and the space program provided.

U.S. manufacturers suggest that the federal government's ability to provide the means necessary to maintain the technological edge of the United States needs to be strengthened. At the roundtable in Minneapolis, Minn., which focused on manufacturers in the medical device industry, many of the participants commented on the need to improve the responsiveness of the Food and Drug Administration to the requirements of a rapidly evolving indus-

try. Currently, the FDA is grappling with the question of how best to regulate the introduction of biotechnology into the marketplace. In the view of some manufacturers, the inability to match the speed of innovation in industry with innovation in government is becoming a drag on what provides the United States its primary advantage in the manufacturing sector—continuing innovation.

Education and Skills

The President's Council of Advisors on Science and Technology (PCAST) recently completed the first phase of a study gauging the health of U.S. high-tech industries. The PCAST report emphasizes a concern that motivated many of the participants in the Commerce Department's roundtables: with continued outsourcing of manufacturing functions to lower-cost alternatives outside the United States, the United States risked losing the "innovation infrastructure of design, research and development, and the creation of new products and industries."²⁵

George Scalise, president of the Semiconductor Industry Association and chairman of the PCAST subcommittee that drafted the report, put it this way:

*Foreign governments—and especially China—have done an effective job of creating a rich environment for the manufacture of electronics and semiconductors, and the implications are that U.S. high-tech leadership is not guaranteed. That is all there is to it. We have it. We enjoy it. We have been here forever, but it is not guaranteed going forward. If we lose that leadership and if we don't have that as a driving force in our economy, it will have an impact on our ability to maintain and further improve our standard of living in the future. That is a reality.*²⁶

The numbers bear out that other countries are increasing their technological

sophistication. The United States, until recently, consumed 40 percent of the world's semiconductor production, meaning that American firms were manufacturing goods containing 40 percent of the world's semiconductors. In the past two years, the U.S. share has dropped to 20 percent, whereas Asia now represents 40 percent of the world's semiconductor consumption.²⁷

One of the principal advantages Asia now holds is a very well-educated technical workforce. Both China and India are graduating high numbers of talented scientists and engineers. In 2002 alone, 58 percent of all the degrees awarded in China were in engineering and the physical sciences, compared with 17 percent in the United States. China's 219,600 engineering graduates accounted for 39 percent of all college graduates, whereas U.S. engineering graduates, a total of only 59,500 engineers, represented a mere 5 percent of all college graduates in the United States.²⁸

Particularly troubling is that comparative advantage in today's manufacturing sector has less to do with physical endowments, such as natural resources, than it has to do with human capital. According to some U.S. firms' estimates, by 2010, as much as 90 percent of their research and development, design, and manufacturing will be conducted in either China or India. There is frankly little government can do through tax, cost reduction, and other policies to prevent this shift toward Asia if the United States is not at the same time providing the talent pool necessary to continue spurring innovation.

The discussions of education, training, and workforce needs in manufacturing at the Commerce Department's roundtables raised the same concerns. Beyond the incentives needed for investment in research and development, manufacturers stressed the importance of a skilled workforce in maintaining America's technological leadership. Chris Bollinger of Bollinger Shipyards, Inc., at the roundtable in New

Orleans, La., identified the “biggest problem that we see” as the “lack of qualified labor.” He indicated that this observation was true even during the recent recession. He expressed concern about what that meant as the manufacturing sector recovered, calling the lack of qualified labor “our biggest issue and our biggest . . . roadblock to continuing to grow.”

From the perspective of most manufacturers, the effort to maintain America’s leadership in innovation and technology must begin with improvements in the basic education delivered by U.S. public schools. Many manufacturers now spend a considerable amount of time and resources simply training their workers to meet the basic skill levels that workers in other countries have attained by the time they enter the workforce.

General Motor’s Mustafa Mohatarem identified the problem at a Washington, D.C., roundtable, noting, “the auto industry was always considered a high-wage industry that would hire people without much education. Your physical skills were much more important than your mental skills. That clearly has changed.” To meet the challenge that this change presents will require continuing improvement in the basic education America gives all students through high school.

Most manufacturers recognize, however, that even a solid high school-level education is not enough to remain relevant in today’s manufacturing sector. Tim Timken of the Timken Company made that point at a roundtable held in Washington, D.C., concerning the future of manufacturing. He emphasized that his company, the world’s leading manufacturer of roller bearings, was increasingly looking for workers who had training beyond high school, up to and including four years of college, for entry into the company’s workforce. The reason for that shift is the increasingly complex capital equipment involved in today’s manufacturing processes.

Manufacturers stressed the need to concentrate increasingly on readying students for the requirements of modern manufacturing and the modern marketplace. They emphasized the potential threat to U.S. technological leadership from declining numbers of engineering graduates and high school graduates with adequate technical skills to qualify for even entry-level jobs in manufacturing today.

Phyllis Eisen of the National Association of Manufacturers captured the views of many when, at a Washington, D.C., roundtable, she offered the following perspective:

We are in a highly competitive state with other countries that have taken education very seriously for a very, very long time—from small countries like Denmark, [which] have been at the peak of pushing kids in the educational world, to China, [which] graduated close to 40 percent of engineers as undergraduates last year. We graduated less than 6 percent. Now this should be a frightening thought to all of us. Manufacturing is an engineering-based industry, and whether we’re training technicians at a very high scale or high performance production workers or engineers and chemists or whatever . . . we’re not doing it fast enough or good enough, and we have to put as much pressure on the education community and ourselves to work with them.

The role of talent is critical to the future viability of America’s manufacturing sector. The 2001 *U.S. Competitiveness Report*, published by the Council on Competitiveness and co-authored by Professor Michael Porter, stated that “the priorities for sustaining U.S. economic growth and competitiveness center on strengthening the nation’s innovative capacity and skills of the American workforce.”²⁹ The report further stated that “the nation’s ability to commercialize innovation—and further productivity growth—rests on the skills of its workers. But, the bar for skills is rising—and demand for higher skills is outstrip-

ping supply.”³⁰ Higher-level skills are essential to enable productivity and commercialize innovation.

Worker skills and education will be a dominant, if not decisive, factor in America’s ability to compete in the global economy. The United States’ ability to engage in the world economy must be accompanied by a commitment to boost the skills of every worker. Educational institutions must respond by giving every American the tools to prosper in the global economy.

The final component that manufacturers focused on in their comments about workforce needs and training was the need to ensure lifelong learning. Nowhere is that need more acute than in the case of workers faced with a layoff because of changes in the underlying economics of their industry.

Traditional trade adjustment assistance programs, though helpful in those specific instances, may not actually address the circumstances faced by most workers laid off during the recent recession who have yet to be called back to work simply because the manufacturer has learned to produce the same quantity of output with fewer workers. That drive to innovate and raise productivity may or may not be spurred by competition from imports, but that debate is increasingly irrelevant in light of the changes under way in the manufacturing sector. There are a number of federal as well as state programs directed at training and retraining workers. The Workforce Investment Act, passed in 1998, has gone a long way toward streamlining and consolidating the efforts of a wide variety of federal job-training initiatives. However, more change is needed to make the system more responsive in a dynamic and rapidly changing economic environment. As a part of that effort, it would also be helpful to work toward programs that actually encourage re-employment. It is widely un-

derstood that the most valuable training and retraining occur on the job. Being out of work, even briefly, means that an individual’s skills are eroding. Programs that put a premium on helping individuals find new employment may be the most important form of adjustment assistance.

Communities and Economic Development

A separate topic is the adjustment of communities. Recent stories of plant closures in the hard-hit textile mill towns throughout the Southeast reinforce the need to ensure closer linkages between community economic-development initiatives and workforce development programs. As a practical matter, job training programs are useful only if there are jobs available for those pursuing the training.

Consistent with the need to upgrade the skills of existing and dislocated workers is the need to ensure that there is a diversified economy capable of employing those workers. Areas with diversified economies are more stable and generally provide for a higher standard of living for their citizens. Communities that are overly dependent on a single industry are at greater risk for economic dislocation.

There is considerable room for communities to engage in thoughtful and proactive economic-development planning. Establishing a comprehensive strategic plan for economic development is a critical element in maintaining a community that can grow, thrive, and endure changes in the economic environment. Coordinated economic development programs can help build a more favorable business climate to attract private investment.

Economic development planning is, furthermore, not just a strategy for adjustment in a particular industry. A sound ap-

worker skills and education will be a dominant, if not decisive, factor in America’s ability to compete in the global economy

proach to economic development can help promote competitiveness, innovation, and increased productivity among existing businesses or industries in the community as well.

One of the development concepts manufacturers highlighted is the concept of clustering. Economically healthy regions can often foster competitiveness and innovation by focusing on industry clusters—groups of interrelated firms and industries. America’s ability to produce high-value products and services that support higher-skill and higher-wage jobs largely depends on the creation and strengthening of these competitive clusters. Significantly, the concept of clusters both draws on and reinforces the benefits of funding for research universities, which often form the core of such clusters.

In general, there is a need for a more aggressive look at how existing economic development programs could best reinforce a community’s development of a sound approach to building a more diversified and strengthened local economy. Reinforcing the focus of communities on building more diversified economic bases is one means of both attracting and retaining manufacturing companies.

Leveling the International Playing Field

Perhaps the key short-term demand of U.S. manufacturers is for a level international playing field. They stressed the importance of international economic policies, on both finance and trade, which ensure that U.S. manufacturers have a fair opportunity to compete.

Disparities in the Cost of Doing Business

According to manufacturers attending the roundtables, one key reason for leveling the international playing field is to address the differences in the cost of doing business within the United States to the costs of doing business in other coun-

tries. Steve Prout of Alpha Q at the New Britain, Conn., roundtable cited the earlier discussed issue of rising healthcare cost as contributing significantly to increased indirect costs that affect competition. “Many of our companies have seen medical healthcare cost increases of 20 percent or greater. You cannot sustain that year after year . . . it’s just impossible.”

Those and other cost differences confront U.S. manufacturers with stark choices and create an incentive to shift manufacturing abroad. As Joe Fusco, of Novus Fine Chemicals, put it at the roundtable in Summit, N.J., “I could throw up my hands. I could shut my factory. I could turn my factory into condominiums . . . and then just ship my manufacturing overseas, and—guess what—I can make . . . more money.”

What Fusco added was also representative of most American manufacturers. While acknowledging the differences in costs that are driving many manufacturers offshore, Fusco also stressed:

I don’t think that that’s the right way to go. That’s just my opinion. I’d like to think that we can be creative and innovative. . . . It’s really about just . . . doing a good job and being productive and [competitive]. And we do . . . But the only thing I’m complaining about is this uneven playing field that I see.

Economic and Trade Policy and Manufacturing Interests

Roundtable participants raised the issue of exchange rates, in particular China’s peg of its currency, the yuan, to the dollar. Many manufacturers expressed concern that exchange rates with a number of trading partners are set by government intervention rather than market forces, leading to lower U.S. exports and stronger import competition. American manufacturers pressed for the market to set the terms of competition, not governments.

Manufacturers attending the roundtables made the same basic point about trade. What most manufacturers asked for was not for protection from international competition, but to level the playing field by lowering trade barriers abroad. As Jay Jackson of Stuller, Inc., a privately held jewelry manufacturer and wholesaler, pointed out at the New Orleans roundtable:

Mexico went to zero percent [tariffs] on precious jewelry in January of 2002. And first quarter of this year, we actually had an 8 percent-plus balance of trade surplus of greater exports going to Mexico than were actually imported, and that's the first time. So we can compete if we're allowed to compete where we have the competitive edge, and we can compete with the low labor cost, but we just have to have that level playing field.

There were serious criticisms of U.S. trade policy. Some manufacturers expressed continuing concerns about the impact of trade agreements, such as NAFTA, and questioned whether continued U.S. participation in the World Trade Organization is warranted.

Other criticisms reflected dissatisfaction with the terms of the agreements themselves, particularly the extent to which they opened the U.S. market to goods made with low-cost labor. Those criticisms were offset, to an extent, by the recognition that, in today's manufacturing, direct labor costs in the form of wages actually represent a small portion of the total cost for most manufacturers, with certain exceptions such as apparel manufacturers.

Further, most manufacturers argued that the global marketplace is here to stay and that the United States is better off using the tools available to ensure that competition in that global marketplace is on even terms. For most, it was clear that

one of those tools is trade negotiations, and many applauded the U.S. initiative within the WTO to eliminate tariffs altogether as the most direct route to ending the current disparity.

Stephen Collins of the Automotive Trade Policy Council, which represents U.S. automakers on international trade issues, echoed that basic point at a roundtable in Washington, D.C.:

The greatest levels of growth are going to be outside of the United States. That's where the U.S. government does have an extremely important role in helping to open those markets through the WTO, through bilateral negotiations, and through regional negotiations. And the reason it's so important is because those governments will try to protect their markets and try to protect the development of their markets during that same period.

That basic point is worth underscoring. Manufacturers understand that tariff protection abroad is not only a barrier to its exports, but it also represents a means of subsidizing foreign manufacturers by limiting the competition they face. In fact, the disparity in tariff rates applied by foreign countries compared with the tariffs applied on goods entering the United States was, apart from the difference in operating costs, the most common example that U.S. manufacturers pointed to in terms of the lack of a level playing field.

Kimberly Hayden of Supreme Tool & Die at the roundtable in St. Louis, Mo., expressed her strong dismay at the disparities in tariff rates, stating what many others voiced at roundtables across the country:

In 2020, if things don't change, we may not be here. That playing field needs to be evened out in order for us to compete globally. I can compete in the United States. I can't compete with the Chinese imports, and I can't import or export my product over there. . . . Bringing a die cast tool into the United States, the total

many manufacturers expressed concern that exchange rates are set by government intervention rather than market forces

taxes equal 3.9 percent. Bringing a die cast tool from the U.S. into China, the taxes equal 30 percent.

Tariffs are not the only trade barrier that U.S. manufacturers face. Another salient example is the lack of adequate intellectual property protection and enforcement in the markets of some of America's major trading partners. For U.S. manufacturers, protection of intellectual property is not an abstract concept. America's competitive edge ensues directly from innovation and rising productivity. Intellectual property protection is the best means for ensuring that American manufacturers enjoy the benefits of their investments in research and development and of their efforts to raise productivity. It is also the means best calculated to ensure that they can enjoy the investment they make in customer service and creating a brand name that distinguishes them from other manufacturers.

As Frank Johnson of the Manufacturing Alliance of Connecticut underscored at the New Britain, Conn., roundtable:

We understand what free trade was designed to be, but free trade isn't free. We want free trade. If there is a tariff on tea going into China and not coming into the United States, that's not fair. If a manufacturer in China can steal pictures from a Connecticut manufacturer's advertising brochure and put them on their Web site and use the company's trademark name to sell products in China, that's not fair. We want fair trade. We understand free trade, but we want it to be fair. We want to level the playing field in every place that we can. We want the Chinese and other competitors to honor trademark laws. We want them to respect . . . to show the same respect to U.S. manufacturers that we show to them.

Indeed, U.S. manufacturers indicated a willingness to compete in a global market, but they want to make sure that the ground rules are the same for everyone and that those ground rules are enforced.

Toward this end, the administration has undertaken a number of significant initiatives to address this issue: an increased focus on intellectual property rights enforcement, heightened efforts to promote the adoption of U.S.-developed technical standards, focused efforts on enforcement and compliance, particularly with respect to China, and expanded export promotion activities.

The rapid globalization of world markets presents American manufacturers with new challenges and opportunities. Falling trade barriers create opportunities in two forms. First, lower barriers to trade open markets for American exports. The United States is already one of the most open economies in the world.³¹ Lowering barriers to trade largely means lowering barriers to trade abroad, where significant barriers still exist.

Second, increased trade brings stronger competition, which represents a double-edged sword for U.S. manufacturers. Although it can place stiff demands on U.S. manufacturers, competition in trade also ensures that American manufacturers remain competitive. Increased competition demands higher productivity, greater efficiency, and greater innovation. In today's global economy, the industries that engage in the constant process of innovation—lowering costs, creating new products, and serving new markets—represent market leaders.

Global competition represents an opportunity for American manufacturers in one other respect as well. Opening markets abroad allows U.S. manufacturers to take advantage of economies of scale that they would not enjoy if they were limited to the U.S. market alone. It also delivers high-quality, low-cost inputs that are necessary to maintain the competitiveness of American manufacturing in many sectors.

In many industries, particularly those in which American manufacturers main-

tain a significant technological or other competitive advantage, there is growth in exports. During the roundtables in Chicago and Minneapolis, several firms indicated that more than 50 percent of their sales are now offshore. That trend holds true for firms throughout the high-technology sector of the American economy.

Most of the manufacturers with whom Commerce Department officials met understand the benefits of trade and indicated that much of what they produce is destined for foreign markets. However, some manufacturers believe that the federal government is not aggressive in defending the interests of American manufacturing in its international economic and trade policy. They argued that the broad opening of U.S. markets through NAFTA was evidence that federal government officials did care about U.S. manufacturing or its competitiveness.

Instead of the terms of the deal, critics of NAFTA focus on Mexico's subsequent devaluation of the peso, which had a far more significant impact on the terms of trade between Mexico and the United States than did cuts in tariffs or quotas. That fact is reflected in the movement of U.S. trade with Mexico from surplus to deficit in the years immediately following the implementation of the agreement.

The lesson many in manufacturing drew from that experience is that the U.S. government, following the implementation of the trade agreement, failed even to acknowledge the implications for American manufacturing of the agreement and the subsequent peso devaluation. The balance of payments adjustment assistance provided to Mexico after the peso devaluation simply reinforced that impression.

In fact, NAFTA has proved to be a boon economically to all parties by making the U.S., Canadian, and Mexican economies more efficient. Indeed, most critics ignore the actual terms of the

agreement under which Mexico had to undertake far more significant reforms and was obliged to remove more trade barriers than Canada or the United States, simply because the U.S. and Canadian markets were already largely open to Mexican products.

Even the most ardent critics of U.S. trade policy, however, were not advocating protection from import competition, nor were they looking for subsidies. Rather, they were looking for a level playing field—an equal opportunity to compete for business both at home and abroad.

Manufacturers showed support for an aggressive trade policy intent on opening markets. Such a policy does not require backing away from current trade negotiations in the WTO or in bilateral, multilateral, or regional free trade agreements. It does, however, require that the interests of American manufacturers, as well as U.S. farmers and service providers, be served by those negotiations and that the U.S. government be vigilant in ensuring that the benefits of the bargains reached at negotiating tables are, in fact, delivered.

It also requires an understanding that trade policy does not take place in a vacuum. During the latter part of the 1990s, trade policy was in a rut because of a debate about the extent to which future trade negotiations should be conditioned on labor or environmental standards. That debate prevented the previous administration from vigorously pursuing, much less obtaining, trade negotiating authority. The debate was also one of the many reasons that the WTO conference in Seattle in 1999 failed to launch a new round of multilateral trade talks.

From U.S. manufacturers' perspective, the politics of the trade debate largely ignore the need for an ongoing effort, without the threat of coercion, to improve

opening markets abroad allows U.S. manufacturers to take advantage of economies of scale that they would not enjoy if they were limited to the U.S. market alone

labor and environmental standards. There is little doubt that there is much to be gained by encouraging economic growth in the developing world. As countries develop, they tend to choose higher labor and environmental standards for themselves. Trade liberalization is one of the most promising means by which to achieve those higher standards.

Concerns Regarding the Trade Deficit

Many manufacturers point to the trade deficit, including the rising bilateral trade deficit with China, as a major concern. While the trade deficit has changed little over the past year and exports have been rising, America's trade and current account deficits reflect broad economic forces, strong U.S. growth relative to growth in America's major trading partners, and a low-inflation environment. Sustained, strong U.S. performance relative to performance abroad has also served to attract substantial capital to the United States to finance the current account deficits. At the most fundamental level, the current account deficit is related to de-

growth in the trade deficit has been driven by relative rates of economic growth and consumption, rather than the competitiveness of American goods and services

velopments in U.S. national saving relative to U.S. investment. When investment is higher in the United States than domestic saving, foreign investors make up the difference, and the United States has a current ac-

count deficit. Increased private saving and deficit reduction in the United States will work to reduce the current account deficit.

The Bush administration's international economic strategy aims for high economic growth throughout the world. At the core of this strategy are the growth-oriented economic policies being implemented within the United States. But working with U.S. trading partners to encourage pro-growth and pro-stability poli-

cies is also a central part of the administration's strategy. Good economic policies in other countries benefit the United States and the rest of the world. It is widely recognized that free markets are best able to allocate scarce resources to their most productive uses. The United States believes that the goals of raising growth and increasing stability can best be accomplished in an international financial system that relies on the principles of free trade, free capital flows, and market-based exchange rates among the world's major economies.

The world economy has strengthened over the past year. Outside the United States, growth in Japan has resumed, and prospects for the euro area brightened in the second half of 2003. The United Kingdom and Canada, as well as many emerging market countries, are also growing more strongly. Rising U.S. exports reflect this greater vitality in America's trading partners.

However, what the broader trend of weak export performance should not obscure is the fact that certain industries have faced, and continue to face, a surge in imports that, in particular sectors, has a stronger impact than the decline in exports. Textiles and apparel are primary examples. The most significant feature shaping those sectors has been the gradual removal of quotas on textile and apparel products that have protected the two sectors since the textile agreements of the early 1960s. Quotas had the effect of maintaining a relatively high level of investment and productive capacity, as well as supporting higher price levels. They also allowed for the existence of sectors characterized by a large number of firms producing a wide variety of products. In addition, they provided an incentive for the establishment of outward processing arrangements to try to maintain industry competitiveness.

As quotas were removed pursuant to the Uruguay round of GATT negotiations,

increased competition lowered prices, dampened profitability, and placed much of the previous investment in apparel under pressure from competition from abroad. In response, apparel manufacturing, which is labor intensive, began to move offshore. Meanwhile, U.S. textile manufacturing, which encompasses increasingly capital-intensive enterprises, began to see its primary customers move offshore or enter bankruptcy. The resulting decline in demand for U.S. textile production has placed the fabric makers in the same difficult financial position that apparel makers faced earlier.

The rise in the trade deficit does not necessarily indicate that American manufacturing is uncompetitive. As mentioned above, growth in the trade deficit has been driven by relative rates of economic growth and consumption, rather than the competitiveness of American goods and services. Many American manufacturers see the playing field being distorted by foreign government intervention.

Most discussions of trade begin and end with a survey of the most recent round of trade talks and what they mean for particular sectors of the U.S. economy. In the past 15 years, a dynamic has unfolded that has complemented and reinforced the impact of trade negotiations in lowering the barriers to trade worldwide as well as the opportunities and challenges lower barriers create for American manufacturers.

U.S. leadership within the context of post-World War II international economic institutions was an important component of the overall effort to ensure the future of freedom, democracy, and a market-based economic system in the midst of the Cold War. Unilateral trade liberalization toward the developing world formed an essential element of American foreign assistance strategy, which was also a tool in achieving broader foreign policy goals. In the long run, however, multilateral trade lib-

eralization by both developing and developed countries would provide the greatest overall benefit.

But some manufacturers expressed concern that the United States has “given more than it has gotten” out of the world trading system and that foreign policy, rather than U.S. commercial interests, drives trade policy. Those views are based on the visible difference between the average tariffs in the United States and those in many markets abroad and on the obvious point that the United States has proved willing to open its market faster than the vast majority of its trading partners. Although the broader reach of U.S. foreign policy certainly was one of the motivating reasons for pursuing trade liberalization, it is difficult to point to a specific area where, as a result of foreign policy concerns, American negotiators put more on the table than they otherwise would have done. The argument also tends to ignore the active role that Congress has played in oversight of the trade negotiation process in defense of particular manufacturing industries’ interests. That oversight alone has ensured that trade policy has normally been driven by commercial considerations.

It is also worth reiterating what those views ignore: the benefits of an open trading environment and the competition it brings. There is little doubt that open economies grow faster than closed economies and that competition is essential. The United States itself has, because of its openness, grown considerably faster than it otherwise would have.

Notes:

¹ Matthew B. Coffey, “NTMA Manufacturing Policy” (paper adopted by NTMA Executive Team, July, 16, 2003).

² PricewaterhouseCoopers, “The Factors Feeding Rising Healthcare Costs” (April 2002).

³ Kaiser Family Foundation and the Health Research Educational Trust, *Employer Health Benefits; 2003 Annual Survey* (Washington, D.C.: Kaiser Family Foundation, 2003).

⁴ Ibid.

⁵ Alliance for Health Reform, *Covering Health Issues: A Sourcebook for Journalists* (Washington, D.C.: Alliance for Health Reform, 2003).

⁶ That is not to say that the total cost of health-care does not take a toll on manufacturers elsewhere. Even in systems like Canada's or Great Britain's, where the government actually provides the health-care, taxpayers, including manufacturing companies, end up paying for it in the form of higher taxes. To the extent that those taxes take the form of value added or similar taxes that are rebated upon export of a manufactured good, the price of the good on international markets may not fully bear the cost of the healthcare system in a way that U.S. goods must, since they are built into the cost base of the U.S. manufacturer itself.

⁷ National Association of Manufacturers, *Health Care Costs at the Crossroads: Manufacturers' Agenda for Lower Costs and Higher Quality* (Washington, D.C.: The Manufacturing Institute, 2002).

⁸ Ibid.

⁹ Kaiser Family Foundation, *Employer Health Benefits 2003*.

¹⁰ Jeremy A. Leonard, *How Structural Costs Imposed on U.S. Manufacturers Harm Workers and Threaten Competitiveness* (Washington, D.C.: National Association of Manufacturers, 2003).

¹¹ Tillinghast-Towers Perrin, *U.S. Tort Costs: 2003 Update; Trends and Findings on the Costs of the U.S. Tort System* (New York: Tillinghast-Towers Perrin, 2003).

¹² Todd Buchholz and Robert Hahn, *Does a State's Legal Framework Affect Its Economy?* (Washington, D.C.: U.S. Chamber of Commerce Institute for Legal Reform, 2002).

¹³ Office of Management and Budget, Office of Information and Regulatory Affairs, *Report to Congress on the Costs and Benefits of Federal Regulations* (Washington, D.C.: Office of Management and Budget, September 1997).

¹⁴ Leonard, *Structural Costs*.

¹⁵ Thomas Hopkins and W. Mark Crain, *The Impact of Regulatory Costs on Small Firms*, report no. PB2001-107067 (Washington, D.C.: U.S. Small Business Administration, Office of Advocacy, 2001).

¹⁶ Ibid.

¹⁷ Ibid.

¹⁸ Leonard, *Structural Costs*.

¹⁹ National Energy Policy Development Group, *Reliable, Affordable, and Environmentally Sound Energy for America's Future* (Washington, D.C.: National Energy Policy Development Group, May, 2001).

²⁰ Ibid.

²¹ Ibid.

²² Ibid.

²³ National Federation of Independent Business, "NFIB Poll Reveals Initial Effects of Deregulation on

California Small Businesses" (press release, Feb. 26, 2001).

²⁴ National Energy Policy Development Group, *Energy for America's Future*.

²⁵ President's Council of Advisors on Science and Technology, "Report on Information Technology Manufacturing and Competitiveness" as reported in *Manufacturing and Technology News* (Oct. 3, 2003).

²⁶ Ibid.

²⁷ Ibid.

²⁸ Ibid.

²⁹ Michael E. Porter and Debra van Opstal., *U.S. Competitiveness 2001: Strengths, Vulnerabilities and Long-Term Priorities* (Washington, D.C.: Council on Competitiveness, 2001), p. 37.

³⁰ Ibid.

³¹ On a trade-weighted basis, the U.S. average tariff is less than 1.7 percent; the current U.S. simple average tariff is 3.6 percent on a legally bound basis under the WTO. Average tariffs throughout much of the world are significantly higher, with simple average WTO legally bound rates of 31.4 percent in Brazil, 37.2 percent in Egypt, 49.8 percent in India, and 39.5 percent for WTO members overall. The manufacturing sector of the U.S. economy is also largely free of non-tariff barriers to trade, such as quotas and trade-distorting subsidies. In addition, because of requirements of the Commerce Clause of the Constitution, there are few barriers to trade within the United States. Taken together, that makes the United States the most open and contestable market of any major economy in the world.