



## Manufacturing Repairs

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**By Ernest S. Christian**

The continuing drastic decline in manufacturing employment has finally set off alarm bells, but such troubles should come as no surprise. Manufacturing has long been on the downhill slide - fewer manufacturers and fewer employees.

Compared to 1950, manufacturing's share of GDP had been cut in half by 2000. Since 2000, manufacturing has been disappearing at the frightening rate of 5 percent yearly, when expressed as a share of GDP. Since 2001, manufacturing jobs have been disappearing at the rate of 2 million per year. Job losses may continue, despite growing prosperity in the overall economy. So uncertain is the outlook many are now, for the first time, asking, "What's wrong?"

Heretofore, except for a few complainers dismissed as "protectionists," the declining role of manufacturing in America has not been seen as a matter of great concern. Typically, it has termed the natural and ultimately beneficial result of free-market forces.

Because America has a mature, high-wage economy, it is said to be to our advantage for other, less advanced countries to do much of our manufacturing for us while we concentrate our own, generally more cerebral, efforts on something of higher value (probably having to do with science and technology). The process of "out-sourcing" manufacturing is said to be particularly advantageous when foreign factories are owned by U.S. capital and use U.S. technology.

But, what if the impending demise of manufacturing in America is not altogether due to natural causes? What if manufacturing's troubles are heavily influenced by malfeasance on the part of government - our own as well as others?

We know currency manipulations have artificially cheapened the price of foreign-made goods relative to American-made. (The Chinese, for example, compound their cheap-labor advantage by depressing the yuan.)

We also know our own tax code has long double-taxed manufacturers - by not allowing them to expense plant and equipment and by taxing dividends. Some partial relief was recently provided by the Bush tax cuts, but, even with full relief, the damage already done is so great it might be many years before manufacturing in America fully recovers from the misguided tax policies of the past. Some lost markets may never be regained.

On a global scale, there is another element of double taxation no one talks about. It occurs through "tax shifting" - the process by which our trading partners, roughly in proportion to U.S. imports plus exports, shift a large part of their home-country VAT taxes onto the backs of U.S. manufacturers. All this is perfectly legal under treaties to which the United States is a party - even though the annual amount of foreign tax shifted to U.S. manufacturers may be so large it equals or exceeds the entire amount of federal income tax our own government imposes on manufacturers.

Consider the case of a U.S. manufacturer who exports American-made products to foreign markets. First, the U.S. manufacturer pays U.S. income tax on its profit. Then, it confronts foreign countries' VAT import taxes that typically are about 16 percent of the gross sales price of the exported product.

The U.S. company has two choices: It can absorb the foreign tax by reducing its pretax price enough that the total "plus tax" price to the foreign customer is not increased. Or the company can allow the tax to increase the price of its product. If the U.S. company absorbs the foreign tax, it will maintain sales volume, but its profits will be less by the amount of the tax. If the company allows the foreign tax to increase the price foreign customers must pay for its product, it will have lower sales. Either way, the economic burden of foreign tax is "backward shifted" to the U.S. exporter.

Consider further the plight of a U.S. company that sells only in the U.S. market. In addition to U.S. income tax, it bears the economic burden of a foreign VAT when it must compete in the U.S. market with foreign manufacturers who are subsidized in their own country by VAT rebates on exports to the U.S.

In effect, the foreign-country VAT is "forward shifted" to a U.S. company that, in order to compete, must reduce its price by the amount of the foreign tax from which the foreign manufacturer is exempted on exports to the U.S. For example, if on Day One the price of widgets is \$100 in both Cleveland and Paris, and if on Day Two the French widget company gets a \$15 tax subsidy for each widget exported to Cleveland, the great likelihood is that on Day Three the selling price of American-made (and French-made) widgets in Cleveland will be much closer to \$85 than to \$100.

When trade is among countries that adjust at the border for imports and exports, tax shifting nets out and has no real effect: Each one's export exclusion offsets the other's import tax and vice versa.

The problem for the U.S. is, of course, that we alone among all major nations are outside the loop. To neutralize the double-tax effect of foreign VATS, we could append to our corporate income tax import and export adjustments comparable to those the Europeans and others have attached to their VATs.

But according to a "Catch-22" provision in the current GATT treaty, we are not permitted to do under our kind of tax system what the Europeans and others freely do under theirs.

According to them, in order to achieve parity, we must abandon our kind of tax system and adopt theirs. But the chances of the U.S. adopting a regular European-style VAT are slim; it has far too much the appearance of a national sales tax to ever fit comfortably on this side of the Atlantic. The better solution is to remove the offending provision from the treaty. It should never have been acceded to by the U.S. in the first place.

If we are not able to neutralize tax shifting with border adjustments of our own, the other solution is to offset the foreign-origin tax burden - it is probably about \$60 billion per year - by reducing U.S. taxes on manufacturers. Full first-year expensing should be the first choice. But other business tax policies, including differentially lower tax rates for manufacturers and, yes, even the existence of the corporate income tax itself, also need to be looked at in a new way that takes into account the total tax burden (U.S. and foreign combined) borne by manufacturers and, therefore, their employees.

The transcendent issue is American jobs. High corporate tax burdens were long thought to harm only shareholders, not employees. That was because many years ago the distinguished economist Arnold Harberger had concluded in the circumstances of the time that the U.S. corporate income tax was borne entirely by capital.

But Professor Harberger has now re-analyzed the problem in modern circumstances and concluded that, in today's open economy, the U.S. corporate income tax is now borne almost entirely by American labor. Professor Harberger reasons that in today's open economy, overtaxed capital can and will move, and that there are people all around the world anxious to fill the jobs capital brings with it.

Let's fix our tax code so we export American-made products, not jobs.

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