Do Manufacturers Need Special Treatment?

By CHRISTINA D. ROMER

EVERYONE seems to be talking about a crisis in manufacturing. Workers, business leaders and politicians lament the decline of this traditionally central part of the American economy. President Obama, in his State of the Union address, singled out manufacturing for special tax breaks and support. Many go further, by urging trade restrictions or direct government investment in promising industries.

A successful argument for a government manufacturing policy has to go beyond the feeling that it’s better to produce “real things” than services. American consumers value health care and haircuts as much as washing machines and hair dryers. And our earnings from exporting architectural plans for a building in Shanghai are as real as those from exporting cars to Canada.

The economic rationales for a policy aimed specifically at shoring up manufacturing largely fall into three categories. None are completely convincing:

MARKET FAILURES Government intervention can be justified on efficiency grounds if the free market won’t work well. For example, when competition in a market is limited, antitrust laws that prevent monopoly can be helpful.

In manufacturing, the market can malfunction if there are positive externalities across companies. That means that some benefits of a manufacturing plant go to companies other than the one deciding whether to build it. Clusters of manufacturing businesses can be more productive than an individual one. As a result, when an entrepreneur sets up a plant, some of the benefits accrue to other businesses in the area.

This argument could justify government subsidies or tax breaks. But large clustering effects have been hard to find. A study by Professors Glenn Ellison of M.I.T. and Edward Glaeser of Harvard showed that in many industries, businesses were only modestly more clustered
than if they were allocated randomly — suggesting that the benefits, while real, may often be small.

Moreover, the logic of clustering’s benefits is likely to apply outside manufacturing. Software development, insurance and entertainment are three service industries where we observe clustering and where positive externalities may be large. Why single out manufacturing for special treatment?

A related argument for subsidizing manufacturing involves learning by doing. It takes time for a production process to become efficient. But whether learning creates a role for government depends on whether the eventual returns are captured by the company taking the risk. If the company that jumps in first and eventually succeeds reaps all the rewards, there’s not a market failure. The company needs to count the learning period as part of the investment cost. And with well-functioning capital markets, it should be able to find investors without government help.

On the other hand, if an early entrant paves the way, but other companies come in later and snatch the rewards, government intervention could be helpful. In this situation, private entrepreneurs may not do as much early investment as would be good for the economy. Still, a study of the semiconductor industry found that although learning by doing was substantial, most of the rewards went to companies doing the early investing. And what spillovers there were, crossed national borders.

The possible externality of greatest concern may be national defense. The argument that we need a strong manufacturing base in case of war must be taken seriously. But it still doesn’t follow that all manufacturing deserves special treatment. Which industries are truly essential in a war effort? And might normal production in military industries, as well as existing supply arrangements with allies, provide adequate protection?

Without compelling evidence of special market failures in manufacturing, it might be better to enact policies that will make all American businesses and workers more productive and successful. President Obama mentioned some in his State of the Union address: expansion and enforcement of free trade agreements; public investment in basic science, infrastructure and education; and corporate tax reform.

**JOBS** A key argument for encouraging manufacturing is to create jobs and reduce unemployment. Unfortunately, those effects are probably small.

Unemployment today is high, but not because of a decline in manufacturing. That decline
has been going on for 30 years — and for most of the 1990s and 2000s, the unemployment rate was less than 6 percent.

Today, we face a profound shortfall of demand. That truly is a terrible market failure, and it warrants government intervention. But we need actions that raise overall demand — like a tax cut for households so they have more take-home pay to spend, more aid to troubled state and local governments, and public investments in infrastructure. These are all things that President Obama has advocated.

A narrow tax cut for manufacturing is unlikely to raise aggregate demand significantly. By making our industrial goods cheaper, it might stimulate foreign demand, but probably not enough to make a dent in our unemployment rate. On the other hand, more aggressive monetary policy that lowered the price of the dollar would stimulate all our exports, and so have far more impact.

At the same time, plant shutdowns by large manufacturing companies leave huge holes in local job markets, and moving is very costly for dislocated workers with ties to their communities. There’s surely a role for government to help these devastated areas.

One little-emphasized component of the president’s manufacturing plan is $6 billion of tax credits for any type of company investing in communities that have suffered the closing of a military base or another major job loss. A spate of new research suggests that such “place-based” policies may be effective in raising local employment and wages.

INCOME DISTRIBUTION A final argument for supporting manufacturing is distributional. Manufacturing jobs are seen as one of the few sources of well-paying jobs for less-educated workers. Indeed, in the four decades after World War II, manufacturing jobs paid more than other jobs for given skills.

But that is much less true today. Increased international competition has forced American manufacturers to reduce costs. As a result, the pay premium for low-skilled workers in manufacturing is smaller than it once was.

Today, manufacturing wages are high largely because production is capital-intensive and technologically sophisticated. As a result, educational requirements have risen. Now, more than half of manufacturing workers have some college education, up from just over 20 percent in 1969.

There are sectors where workers with good educations could earn good wages if the
economy were healthy. Why focus on manufacturing to create such jobs? Instead, government could make it easier for workers to get the education needed for high-skilled jobs in many fields — and encourage business formation wherever entrepreneurs see a promising opportunity.

If increasing income equality is the goal, it might be wiser to put money into infrastructure than to subsidize manufacturing. Construction also pays good wages, but with lower educational requirements. And America’s infrastructure needs are enormous. Or, we could redistribute income through the tax code — economists’ traditional tool.

As an economic historian, I appreciate what manufacturing has contributed to the United States. It was the engine of growth that allowed us to win two world wars and provided millions of families with a ticket to the middle class. But public policy needs to go beyond sentiment and history. It should be based on hard evidence of market failures, and reliable data on the proposals’ impact on jobs and income inequality. So far, a persuasive case for a manufacturing policy remains to be made, while that for many other economic policies is well established.

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