BREAKING THE BARRIERS TO U.S. ECONOMIC GROWTH

John M. Albertine

Introduction

We all know what a popular buzzword "industrial policy" has become in Washington these days. The trouble seems to be that the term "industrial policy" means different things to different people. To me it means a set of generic policies that break barriers to economic growth. To some liberal Democrats industrial policy means extensive, intrusive government planning and targeting.

The truth of the matter is that industrial policy is not a new idea. We have had an implicit industrial policy in the guise of an informal set of tax, economic, and regulatory guidelines since World War II. The problem is that our industrial policy has not been very good. In fact, more often than not, it has been totally irrational. There have been tremendous weaknesses in the ways in which our tax laws, regulatory policies, and economic programs have interacted. They have conspired to give us an industrial policy that has thwarted growth more often than it has encouraged it.

The Wrong Approach to Industrial Policy

Some believe that we should take an interventionist approach to industrial policy. They believe that the government should pick prospective winner industries in our economy and coddle them until they boom. I am completely opposed to this strategy, because I think it takes a naive view of how the political process works in America today.

First, it would be impossible to depoliticize the process of picking the winners. No matter what saints were hired to make the decisions,

---

Cato Journal, Vol. 4, No. 2 (Fall 1984).

The author is President of the American Business Conference. This paper is adapted from his opening remarks at the Cato Institute's conference, "Planning America: Government or the Market?" (April 28, 1984).

politics would eventually come into play. Some claim that no one would ever try to politicize something as important as our national industrial policy—just as no one has ever tried to siphon our defense dollars for pork-barrel projects.

Second, the government cannot make a decision quickly. The federal government does not do anything quickly. It cannot even deliver the mail quickly. The venture capital market can make decisions much more rapidly.

Third, however well-intentioned, the government is wrong quite often. When venture capitalists are wrong, they cut their losses and move on. When government officials make mistakes, their errors go undiscovered for a long time, because no one wants to take the blame. Everyone involved claims that it is not really a mistake after all. Then Congress holds hearings. About the time that the executive and legislative branches finally agree, the lawsuits start.

We are the world's most litigious society. If the government had been picking winners for the last century, the appeals of the buggy whip manufacturers would still be before the Supreme Court.

Rather than an interventionist industrial policy, I think we would be much better off with one which allows the market to make most of the decisions. If we look at the roots of our economic ills, I think it will be easy to see why this approach would offer the correct cure.

Our Major Economic Problem: Poor Productivity Performance

Sluggish productivity growth was the cause of the malaise which descended upon our economy in the early 1970s. Weak productivity led to high inflation; it eroded real incomes; it increased unemployment; it weakened our trade balance; it depressed our standard of living.

According to a recent study by the Joint Economic Committee (U.S. Congress 1980), the capital/labor ratio is the key explanatory variable in the productivity equation. The index of the capital/labor ratio declined steadily throughout the 1970s. Our poor productivity performance during the last decade can be attributed to the confluence of demographic changes that increased the labor force and tax policies that discouraged capital formation.

A record number of people, about 22 million, entered the labor force in the 1970s. This expansion in the labor force was a result of the postwar baby boom and the more active role of working women. However, the rate of growth of capital formation did not keep pace with the growth in the labor force. Indeed, in the 1970s, the United States invested a smaller percentage of its GNP than did its major trading partners. As a result, U.S. workers, on average, had less capital at their disposal. The demographic changes are unlikely to recur, but the capital formation problem continues. The reasons for the capital insufficiency are complex, but tax policy is one of the main culprits.

Before 1981 the congressional tax writing committees focused on achieving "tax equity," and "tax equity" meant tax policies that sought to equalize the after-tax incomes of all Americans by redistributing income. This philosophy produced a tax system with high marginal rates and an inherent bias against savings and investment. Income produced by thrift and risk-taking was labeled "unearned" and taxed at essentially confiscatory rates. Pre-1981 tax policy favored consumption at the expense of savings and investment, and it was a key component of the irrational industrial policy of the postwar era.

The ERTA Experience

Once low productivity was recognized as the underlying cause of our economic distress, economic policy did an about-face. In 1981 tax policies were changed to spur investment, particularly in the large, capital-intensive industries (such as autos, steel, and heavy manufacturing) which had dominated the American economy in the first half of the 20th century. The penalties for savings and investment were finally reduced, however slightly.

The Economic Recovery Tax Act (ERTA) of 1981 favored general capital formation. A consensus among policymakers made the liberalization and simplification of depreciation the top priority. However, depreciation reform was viewed as insufficient. The large, capital-intensive industries in declining sectors of the economy still had large constituencies in Washington. Hence the right to sell tax credits was given to firms not profitable enough to take full advantage of the new tax breaks.

Despite all the hoopla over ERTA, it turned out to have very little impact, because the high-inflation, low-productivity economic policies of the 1970s finally caught up with us. ERTA precipitated a comparatively small drop of only 1.2 percentage points in the total cost of capital services for corporations. Interest rates soared and completely swamped the effects of ERTA. This led some to conclude, incorrectly, that increasing incentives was insufficient, and large-scale intervention would be necessary to stimulate investment.

To Stimulate Investment, Lower the Cost of Capital

There is plenty that the government can do to raise productivity and increase our competitiveness without large-scale government intervention. Lowering the high cost of capital is on the top of my list, because this would spark greater investment. The American Business Conference is working on a study of the need to lower the cost of capital in this country. One of the members of the ABC, Dr. George Hatsopoulos, chairman of the Thermo Electron Corporation, is supervising the study, and he has employed some of the best young economists in this country to assist him. The recent findings show that the cost of capital in the United States is about triple the cost of capital in Japan (Hatsopoulos 1983).

Our study shows that high U.S capital costs have precipitated the deterioration in the competitiveness of U.S. firms in world markets. For example a car containing $10,000 of U.S. labor and capital would cost only $4,900 in Japan. The lower marginal cost of capital in Japan accounts for $2,300 of the cost savings in Japan.

The cost-of-capital differential between our country and Japan has important implications for the development of the high-technology sector, the sector upon which so many are pinning their hopes for an Amercian economic resurgence. The Hatsopoulos study shows that for a project requiring five years of development and having the same probability of success in the United States as in Japan, the enormous disparity in the cost of capital would mean that Japan could invest two and a half times as much as would be justifiable in the United States. For a project requiring 10 years of development, Japanese businessmen would be able to justify spending five times as much as Americans, solely on the basis of their lower capital costs.

Americans are very smart and innovative, but we are not five times as smart and innovative as the Japanese. Since the Japanese will be able to undertake much more research and development, they may well be able to outstrip our much-heralded high-tech sector.

The structure of our tax code is one of the key factors contributing to higher capital costs in this country. The differential in capital costs is not simply the result of the numerous Japanese incentives for savings. U.S. financial regulations, the Glass-Steagall Act, and standard U.S. management practices encourage U.S. firms to seek equity financing. Most U.S. corporations have a debt-to-equity ratio of 1 to 3, while it is 3 to 1 for most Japanese firms. Since the return on equity is taxed twice in this country—at the corporate level and at the personal level—U.S. firms must offer a much higher pre-tax rate of return in order to offer a competitive after-tax return. The combination of an institutional/regulatory preference for equity and the tax treatment of equity puts U.S. firms at a real disadvantage.

The ABC is currently looking at a number of ways in which the cost of capital can be lowered. One of the mechanisms that we are studying right now is to allow deductibility of dividends on new equity issues.

Another is a further reduction or elimination of capital gains taxes on investments in equities. In a corporate world that is dependent on equity financing, the level of the stock market is a key determinant of the cost of capital. The stock market boom of the early 1980s did more to lower the cost of capital than did the drop in interest rates or the 1981 legislation liberalizing depreciation.

There is considerable evidence that the 1978 reduction in capital gains taxes helped to foster the advance in stock prices and, as a result, lowered the cost of capital for American business. In fact I think the reduction in capital gains taxes was the single most important economic policy undertaking of the 1970s. It was a brave and creative step, because it broke barriers to U.S. economic growth.

More-Efficient Investment

The quantity of investment is not the only issue—the quality is important too. The United States not only underinvested in the 1970s, it got less bang from its investment buck. While liberalized depreciation should raise capital investment in the long run, it will not address the declining efficiency of investment. In a time of budget crisis, when tax incentives are increasingly hard to justify, we must make sure that our policies will deliver the greatest productivity enhancement possible for each dollar of tax incentive.

The New York Stock Exchange's Office of Economic Research (1979) has developed a measure of the effectiveness of investment called the investment efficiency ratio (IER). It measures how much real growth the economy produces for each dollar of real nonresidential investment. The higher the real growth produced by each investment dollar, the higher the IER for the economy. During the 1950s the IER averaged 30.2 percent; in the 1960s it declined slightly to 27.1 percent; but in the 1970s the IER dropped dramatically to 12.8 percent.

While part of the solution to our productivity problems will come through a generic decline in the cost of capital for all American firms, we must encourage the allocation of resources to those firms and industries which will use them most efficiently. We must facilitate the expansion of the firms of the future, rather than propping up declining industries. One of the ways of doing this is to eliminate (or, at least, reduce) the biased and inefficient corporate income tax.

The Corporate Income Tax: A Case of Inefficient Economic Policy

Few tools of economic policy skew the allocation of resources as much as the perversion known as the corporate income tax. It is a tax on production, and it causes nonoptimal allocations of our scarce resources. It may be the biggest barrier to economic growth in our country. Moreover the corporate income tax is one of the least efficient ways of raising revenue. Sooner or later the corporate income tax should be abolished.

First of all, the corporate income tax is not paid by corporations. It is paid by consumers, shareholders, and workers:

- It is shifted forward to consumers in the form of higher prices.
- It is shifted backward to stockholders in the form of reduced dividends.
- It is shifted backward to stockholders in the form of lower retained earnings and the consequent lower net worth of corporations.
- It is shifted backward to workers in the form of lower wages.

What this means is that consumers, stockholders, and workers are paying a hidden tax. Some labor unions support higher corporate taxes and are unaware that it is their members who will actually pay the additional tax. There is a total lack of accountability for the burden of the corporate tax, and that is why politicians are so enamored of raising corporate taxes.

There is a second reason why the corporate income tax is poor economic policy. The consensus of tax economists is that most of the corporate tax is shifted backward—it is a tax on labor and capital. As such it is really a tax on production and slows the growth of American industry. The corporate income tax makes our most distressing economic problems—expensive capital and low productivity—much worse. It is a real roadblock to economic growth. The burden of the corporate tax should be shifted away from workers and investors, because they are what this economy needs most of all.

The third fault with the corporate tax is that it is not symmetrical. All firms do not pay the same rate. Large, established, capital-intensive firms generally pay much lower tax rates than smaller, rapidly growing companies. The American Business Conference—a coalition of 100 firms that have annual revenues between $25 million and $1 billion and that have doubled in size over the last five years—studied this issue (Cavanagh and Clifford 1982). They found that the highly successful ABC companies paid effective tax rates that were nearly double those of the Fortune 100.

The "Pease-Dorgan Study," recently completed by the Joint Committee on Taxation (U.S. Congress 1983), confirmed the wide variations in effective tax rates. The trucking industry paid effective rates averaging about 40 percent over the 1980–82 period, while the chemical industry paid only 4.3 percent. The computer industry paid almost 26 percent, while the paper industry enjoyed negative effective tax rates.

This lack of symmetry causes a misallocation of resources. If you could make a $10,000 investment that would have the same pre-tax payoff in either computers or paper, the tax code would force you to put your money in paper. The existence of the corporate tax thwarts the efficient allocation of resources. It skews resources away from high-tax industries—often new, rapidly growing entrepreneurial sectors—and toward low-tax industries—frequently older, declining sectors with high-priced lobbyists. Our resources would be allocated much more efficiently, and our nation's output would be higher in the absence of a corporate income tax.

Proposals to impose a corporate surtax would only exacerbate the asymmetry problems associated with the corporate tax. A surtax would render the allocation of America's resources less efficient. A corporate surtax looks good on paper, because it is a hidden tax and appears to be an equitable tax. However, because of the wide differential in effective tax rates, it is a very inequitable tax. Those already paying the highest tax rates would pay the most. Those paying the lowest rates would pay the least. Since it would result in further misallocation of our resources, it would certainly not be consistent with long-term economic growth.

Good economic policy strives to increase national output and make our economy more competitive. This means that we should try to reduce marginal corporate rates in order to eliminate the biases in effective corporate rates. We should work toward the overall abolition of the corporate income tax and replace the lost revenue with taxes which do not penalize savings and investment. We must turn away from taxes which penalize production and thwart savings and investment, and turn toward generic policies which offer incentives for production, thrift, risk taking, and investment.

Tax Reform Is Not Enough

A generic industrial policy that includes tax policy changes which lower the cost of capital and reduce marginal corporate tax rates will increase economic efficiency and have a high productivity payoff. Yet our implicit industrial policy extends far beyond our tax code. We should examine our regulatory apparatus and export-promotion programs to see how they affect high-growth entrepreneurial firms. We must try to remove all the roadblocks to economic growth.

This means procedural regulatory reform, not just reform of individual statutes like the Clean Air Act. There is irrefutable evidence that entrepreneurs are methodically overwhelmed by the complexity of federal and state regulatory programs. Revision of individual statutes will not have much impact, even at the margin.

One positive step in the process of formulating an efficient industrial policy was the passage of the Export Trading Company (ETC) Act in 1982. Programs like the ETC assist high-efficiency investors. They are entrepreneur oriented.

Conclusion

Our tax code and regulatory apparatus create an implicit, de facto industrial policy regardless of whether the Congress or the administration desires one. In this time of budgetary cutbacks, our limited resources must be used as efficiently as possible. While there will inevitably be transitional disruptions in the short term, it is time to change the focus of our industrial policy from shoring up our declining industries to stimulating entrepreneurship and the efficient flow of resources within our economy.

Our industrial policy must favor efficient, productivity-enhancing investment. We can no longer afford the productivity losses associated with the anti-investment industrial policy of the 1970s nor the slow recovery in productivity will result from the general investment policies of 1981. The market works, and with the policies that I have outlined here, we can allow it to work even better. The engine of American economic growth does not need a complete overhaul. It just needs a little more free-market oil.

The interventionist industrial policies advanced by liberal economists and aspiring philosophers sound great on paper, but they will not work in practice. If the government had begun picking winners when interventionist industrial policies were first discussed, our children would probably still be playing with hula hoops, instead of computers. What we should do is adopt generic industrial policies that systematically remove roadblocks to economic growth.

References

Cavanagh, Richard, and Clifford, Donald. *The Winning Performance of Mid-Sized High Growth Companies.* Washington, D.C.: American Business Conference, 1982.

Hatsopoulos, George N. *High Cost of Capital: Handicap of American Industry.* Washington, D.C.: American Business Conference, 26 April 1983.
Office of Economic Research. *Building a Better Future: Economic Choices for the 1980s.* New York: New York Stock Exchange, December 1979.
U.S. Congress. Joint Economic Committee. *Special Study on Economic Change,* Vol. 10, *Productivity: The Foundation of Growth.* Washington, D.C.: Government Printing Office, 1980.
U.S. Congress. Joint Committee on Taxation. *Study of the 1982 Effective Tax Rates of Selected Large U.S. Corporations.* Washington, D.C.: Government Printing Office, 14 November 1983.

A PRO-MARKET NATIONAL INDUSTRIAL POLICY

Richard B. McKenzie

The small but highly visible group of economists and industrialists who are pressing for the United States to establish a national industrial policy have colorfully but inaccurately painted a picture of a U.S. industrial economy in decline. Harvard University Professor Robert Reich, one of the gurus of the new mythology, warns that the economic system is so fettered with special privileges for politically powerful business interests that it will continue to unravel during the 1980s unless government intervenes to help business "adapt" to new competitive pressures (Reich 1983, p. 3). And, of course, his own menu of industrial policies is just the solution needed to get things going again. Boston College Professor Barry Bluestone and MIT Professor Bennett Harrison bemoan the tens of millions of jobs destroyed over the past decade by a capitalistic system they view as more concerned with profits for owners than the human welfare of workers and consumers (Bluestone and Harrison 1982). They, too, know that with their direction the government will be able to fix things.

Senator Gary Hart is more philosophical. He maintains that conventional government policies of the past have become "increasingly irrelevant to the unique economic realities of the decade." Such a predicament can only be relieved, Hart attests, by "melding" the "Jeffersonian principle of free competitive economy" with the "Rooseveltian principle that economic success cannot be divorced from social conscience" (Hart 1982, p. 4).

The path to economic salvation, Bluestone, Harrison, Reich, Hart, and the others believe, is paved with greater government intrusion in the economy: more government expenditures for a wide variety of social services, more government protection from competition,

Cato Journal, Vol. 4, No. 2 (Fall 1984).
The author is Professor of Economics at Clemson University.

and bailouts for businesses. In effect they recommend a time-tested problem as the solution. John Albertine's (1984) assessment of the country's economic problem is welcomed for its accuracy and because it points the way to realistic and viable, politically plausible solutions.

The national industrial policy lobbyists, however good their arguments may sound, are selling snake oil. Even Brookings Institution senior fellow Charles Schultze, advisor to Democratic presidents, has concluded (1983, p. 4): "America has not been deindustrializing. Throughout the industrial world, economic performance in the 1970s did fall behind the records of the 1960s. But relative to the industries of other countries, American industry performed quite well by almost all standards." A recent study by George Mason University economist Thomas DiLorenzo illustrates this clearly. He points out that in the 1950–81 period manufacturing output in real terms stayed in the range of a quarter of GNP, except during recessions (1984, p. 3).

The goals of the national industrial policy proponents—to save and create jobs—are admirable. In fact they are commonly shared by proponents and opponents alike. However, the proposed remedies are bound to do more harm than good:

- Proposed increases in government expenditures for a wide variety of social welfare services will add to the ballooning $200 billion federal deficits. Many economic analysts are convinced this could crowd out private investment—and jeopardize and destroy jobs in the private sector.
- Proposed business bailouts with subsidies and loan guarantees from a reconstructed Reconstruction Finance Corporation will serve only to impose greater tax and interest burdens on firms that have kept their costs, including wages, competitive for the benefit of mismanaged, noncompetitive, but politically powerful established firms in need of government aid.
- Proposed protection from foreign competition by way of "domestic content bills" and/or higher tariff and quota walls will raise the prices American consumers must pay for their goods and reduce the real incomes of Americans. At the same time, because of the inevitable two-way nature of international trade, protection that obstructs imports will also lower exports and jeopardize the jobs of the five million workers in the country's export industry.
- Proposed "tripartite councils," designed to establish national economic goals and chart central plans for the country, will "collectivize," "politicize," and "bureaucratize" economic decisions in the country and, to that extent, will cramp the ability of American firms to adapt and compete on international markets.

As Schultze (1983, pp. 10–11) has stressed, "[I]t is a curious logic to cite examples of how the American industrial structure has been distorted by political pressures in support of an argument for entrusting even more economic decisions to the same political process."

Few deny, however, that continued changes in federal policy are needed to spur long-term economic growth. Dr. Albertine has suggested a number of important policy changes. He proposes, in effect, an alternative set of industrial policy recommendations that place more, not less, reliance on market processes. My only comment is more needs to be done. *The Blueprint for Jobs and Industrial Growth,* which I edited for the Heritage Foundation (1984), spells out an alternative industrial policy. That program is founded on a limited number of several guiding premises that can be outlined as follows.

First, long-run growth in private industry requires reducing federal deficits to tolerable levels and stabilizing monetary growth. Congress, especially, must curb its spending, or be disciplined by balanced budget/spending limitations.

Second, antitrust policies must not continue to be "anticompetitive" policies. Hence the focus of enforcement policy must be shifted to artificial barriers to entry and away from firm size and industry concentration, which often are the consequence of highly competitive market processes and present no threat to competition. The "rule of reason," which effectively abolishes the automatic trebling of damages in antitrust cases (except in overt cases of monopoly practices), must be institutionalized to reduce attempts by businesses to obstruct competition through nuisance suits—the central purpose of which is often to force firms to agree to lucrative out-of-court settlements rather than spending years of valuable time and millions of dollars defending themselves in court. State and municipal organized and condoned monopolies should be no more exempt from antitrust law than any other privately inspired cartel. All monopolies should be subject to the same legal constraints.

Third, social and environmental regulations must be reevaluated to ensure that undue costs are not being imposed on American producers. Specifically, cost-benefit analysis must figure more prominently in regulatory decisions, especially in the development of performance standards that should be more widely used in lieu of engineering standards; and current and wasteful conflicts among regulatory policies in government agencies must be reconciled by a coordinating agency. The deregulation of the transportation industry should be completed with the elimination of all remaining government-inspired entry and pricing restrictions.

Fourth, international competition mandates that we employ every means available to achieve all regulatory standards in the most cost-effective way. This means we should expand the use of the "bubble concept" in pollution control, providing industry with a more creative method for reducing air pollution. It also means we should give firms greater flexibility in selling their "emission standards," a market process that permits enhanced environmental quality at lower firm cost. Finally, it implies that the emerging "water crisis" must be averted in part by the assignment of property rights to water, a policy that will result in greater water conservation, a reallocation of the country's water supplies to higher-valued uses, and greater national output at lower cost in money and water terms.

Fifth, policies must be altered to encourage saving and capital formation. As Albertine argues, this requires lowering the double taxation of savings and capital by exempting a larger proportion of personal and business savings from taxation, lowering the corporate income tax, and reducing immediately (and eventually removing) capital gains taxation (bringing our tax system more in line with the Japanese system). It means also that we recognize that depreciation schedules for capital assets discriminate arbitrarily against fast-growing, especially high-tech, industries in which capital obsolescence is accelerating. We must move toward "immediate expensing" of all capital purchases.

Sixth, a reinvigorated growth-oriented economy requires that savings be allocated to their highest-valued use. This can be accomplished in part by amending the Glass-Steagall Act to allow, once again, banks to act as investment bankers and the McFadden Act to permit interstate branch banking. We must also replace the Federal Deposit Insurance Corporation with a system of private deposit insurance that will encourage rational, price-constrained, risk taking on the part of banks. The deregulation of the services provided by U.S. financial institutions must be completed to enhance the returns to savers, which will foster greater saving.

Seventh, labor policies must be revamped to ensure that government is not creating and prolonging unemployment. This objective can be partially met by replacing the federal supplemental unemployment compensation program (which induces extended unemployment) with a program of unemployment loans; by adjusting unemployment insurance rates to more accurately reflect the unemployment experience of firms (and thereby reducing the subsidy going to firms that create the unemployment problem); by freezing the minimum wage for adults and setting a "subminimum wage" for teenagers; and by repealing or modifying laws, such as the Davis-Bacon Act, that reduce employment opportunities by artificially hiking the costs of federal projects. In addition more cooperative labor-management working environments can be encouraged by once again allowing "company unions" to compete in union elections supervised by the National Labor Relations Board. And competitive labor markets can be encouraged by amending the Hobbs Act to ensure that labor violence that obstructs interstate commerce is, once and for all, a federal crime.

Eighth, economic development is critically dependent upon improvement in the public education system that, in turn, is dependent upon breaking the public school monopoly. Serious reform requires meaningful parental choice must be reintroduced into the education system by way of education vouchers and tax credits for private school expenses.

Finally, let us agree that federal programs that require more federal expenditures and are designed to save and create jobs must be evaluated fully and carefully by Congress. This means that legislation designed to subsidize and protect American firms must be accompanied by "economic impact statements" that provide (1) estimates of the number of jobs saved and created in identified industries by the expenditures; (2) estimates of the number of jobs jeopardized or destroyed in identified industries by the financing requirements; and (3) a rationale for the government destroying the jobs of some workers for the benefit of others.

There are many things the federal government can do to accomplish the objectives of the industrial policy advocates without extending the meddling arm of government in the economy. Dr. Albertine has provided a list that has been extended here. The government should take these steps as soon as possible and set aside the national industrial policies proposed by industrial policy advocates who contine to set up their soapboxes along the presidential campaign trail.

References

Albertine, John M. "Breaking the Barriers to U.S. Economic Growth." *Cato Journal* 4 (Fall 1984): 609–17.

Bluestone, Barry, and Harrison, Bennett. *The Deindustrialization of America.* New York: Basic Books, 1982.

DiLorenzo, Thomas J. "The Myth of America's Declining Manufacturing Sector." The Heritage Foundation *Backgrounder,* 13 January 1984.

Hart, Gary. "Restoring Economic Growth." A policy statement presented to the National Committee Strategy Council, 6 February 1982.

McKenzie, Richard B., ed. *A Blueprint for Jobs and Industrial Growth.* Washington, D.C.: The Heritage Foundation, 1984.
Reich, Robert. *The Next American Frontier.* New York: Times Books, 1983.
Schultze, Charles L. "Industrial Policy: A Dissent." *The Brookings Review* 2 (Fall 1983): 3–12.