

**BRIEF ANALYSIS**

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## The State of U.S. Manufacturing

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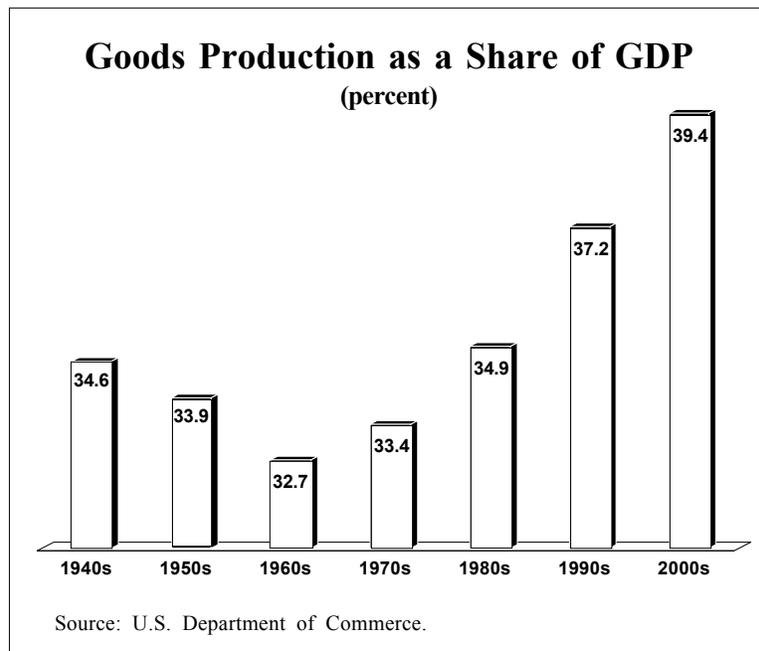
Everybody seems to be worried about manufacturing these days. For years, manufacturers have been outsourcing operations to foreign countries to lower labor costs and escape high taxes, government regulations and union demands. Falling manufacturing employment in the United States has led to a widespread impression that the industrial sector of our economy is declining. Critics of free trade on both the left and right are proposing more trade protection to keep out foreign goods — or at least to save American jobs.

The truth is that U.S. manufacturing is doing quite well in every way except in the number of people it employs. Furthermore, few economists would judge the health or sickness of any industry based solely on employment. By that standard, agriculture has been the sickest industry of all for decades because employment has declined — although farm productivity rose dramatically in the past century. Industrial health is better measured by output, productivity, profitability and wages.

**Manufacturing Employment.** Let us begin with the bad news. According to the Bureau of Labor Statistics:

- The most recent peak for manufacturing employment occurred in March 1998, reaching 17.6 million.
- Manufacturing employment declined 16 percent in 3 years, to 14.6 million Americans in July 2003 from 17.3 million in 2000.

It is important to remember that much of the change in industrial employment is an effect of changes in the classification of various jobs. Big companies used to do everything in house, so that people like janitors and accountants were classified as “manufacturing” workers simply because they worked for manufacturing companies. Over the years, such companies discovered that it was more economical to outsource such work. That is why “business services” is one of the fastest rising categories of employment in the United States.



**Manufacturing Output.** In contrast to employment, industrial production has remained relatively strong. The Federal Reserve Board’s industrial production index — which covers industrial sector output, capacity and capacity utilization — has fluctuated only slightly since 1998, despite a recession in the meantime.

Considering total goods production (including things like mining and agriculture in addition to manufacturing), real goods

production as a share of real (inflation-adjusted) Gross Domestic Product (GDP) is close to its all-time high.

- In the second quarter of 2003, real goods production was 39.2 percent of real GDP; the highest annual figure ever recorded was 40 percent in 2000. [See the Figure.]
- By contrast, in the “good old days” of the 1940s, 1950s and 1960s, the United States actually produced far fewer goods as a share of total output, reaching 35.5 percent in the midst of World War II.

Looking at manufacturing alone, over the long term one finds it has also grown. In 2001, in inflation-adjusted terms it was 16.2 percent of GDP, which is higher than it was during the recession of 1991 (16 percent).

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It is critical to adjust the figures for inflation in order to make a valid comparison. The price of many goods such as computers has fallen sharply. Since GDP data are calculated in money rather than volume terms, failure to account for price changes gives a distorted picture. For example, suppose the output of a product rose by 10 percent in terms of units while falling 10 percent in price due to higher productivity. Using nominal dollar figures makes it appear there was no increase in output. Using real data captures the increase.

**The Effect of Imports on Output.** One common complaint is that U.S. companies are simply reselling goods actually manufactured in China. This is just a misunderstanding of how GDP is constructed. All imports are subtracted from final sales to calculate GDP. Therefore, goods imported from China or anywhere else can never raise GDP; they always cause it to be lower than if they were produced domestically. GDP measures only actual production on U.S. soil.

The equation goes like this: In 2002, final sales to domestic purchasers equaled \$10,866 billion. Add \$3.9 billion for the change in inventories nationwide, add \$1,014.9 billion for exports, and then subtract \$1,438.5 billion for imports. This leaves a net figure of \$10,466.3 billion for GDP. In short, imports reduce GDP and exports increase it.

**Comparing Productivity Worldwide.** Manufacturers are not concerned about hourly wage rates, but unit labor costs — how much the labor costs to manufacture a given product. If a U.S. worker earns five times as much and is five times as productive as a Mexican worker making one-fifth as much and producing one-fifth as much, the workers are exactly equal from the point of view of the producer.

The best measure of comparative productivity levels is real GDP per employed person. According to the Bureau of Labor Statistics, in 2002 the United States continued to lead the world in this category.

- U.S. workers produced an average of \$71,600 in output (in 1999 dollars), followed in a not-so-close second by Belgium, where each worker produced \$64,100.

- Japanese workers — renowned for their productivity — each produced just \$51,600 and Korean workers produced even less: \$34,600.

It is also notable that virtually every other major country has seen declines in manufacturing employment. Like the United States, manufacturing employment in Britain, Japan, and Germany also fell between 1992 and 2002.

**Protection Harms Manufacturing.** Protectionism is not a solution to manufacturing's problems. The best way to help manufacturing is by raising economic growth throughout the U.S. economy.

The steel tariffs imposed by President Bush on March 5, 2002, for example, cost more jobs in steel-consuming businesses than they saved among steel producers. Last February, the Consuming Steel Industries Trade Action Coalition estimated that, while the steel industry employs a total of 187,000 people, the tariffs cost 200,000 jobs among steel-consuming industries — which includes manufacturers who use steel to fabricate finished products. The tariffs raised the cost of steel to these industries, making the products they export less competitive in international trade.

Restricting imports by imposing quotas or tariffs also invites retaliation by foreign countries. The trade deficit might even rise because exports would fall more than imports fell. In the long run, trade protection has never worked in any country at any time. The long-term effect has always been to impoverish nations that engage in it.

**Conclusion.** In short, U.S. manufacturing is very healthy. There is absolutely no evidence whatsoever that we are becoming a nation of “hamburger flippers.” The United States is producing more “things” than we have in almost every year for which we have data. The decline in employment is a good thing because it signals that manufacturing productivity is very high and that manufacturers can afford high-wage U.S. workers while still competing with low-wage workers in the developing world.

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