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Testimony Given By

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Industrial Policy and National Security

I. De-industrialization and National Defense

That the nation's industrial base is vital to our national security was for most of our history a core assumption of American economic policy. The manufacturing sector had been a driver of our prosperity, a guarantor of our independence, and the basis of our rise to world leadership. Had the United States not had the capacity to become the "arsenal of democracy," the Second World War might well have ended differently.

The war's end left the U.S. as the dominant manufacturing power in the world for some three decades. Our ability to provide our military with the most advanced weaponry and our civilians with the most advanced consumer goods were two sides of the same policy coin—with both sides crucial to the United States prevailing in the Cold War.

But, as we all know, over the last several decades the American industrial base has dramatically weakened. Economists debate the exact causes, but the decline in U.S. manufacturing has been thoroughly documented, and widely acknowledged by both policymakers and the public. We have been running trade deficits in manufacturing for over thirty years, relentlessly off-shoring production and steadily losing ground in our capacity to produce cutting edge technologies.

Yet, the threat to our national security has not been reflected in our economic policies, or the way in which we are organized to meet the national security challenges of the future.

Our shrinking manufacturing capacity undercuts our national security a number of ways:

1. We have become more dependent on other nations for vital products and parts. As the supply lines for our industrial production stretch around the world, so has a growing share of components for our military systems now come from abroad.

2. As the industrial base has hollowed out, it will become much more difficult to ramp up domestic production in a time of national emergency. The

relatively simple technology of World War II enabled us to quickly train unskilled workers to perform rote tasks on an assembly line. Today's manufacturing systems demand specialized skills and training. Without a pool of such workers from the civilian sector to call on, the United States will have a much harder time adjusting to wartime and/or terrorist disruptions of overseas supply lines.

3. Innovation, design, and engineering follow production. For years, U.S. policymakers rationalized the movement overseas by manufacturing on the grounds that the technical jobs and capacity would remain in the U.S. Today that capacity is also shrinking fast. The diminished share of young people going into engineering and other technical education is no surprise. They understand that on this nation's present trajectory there is very little future for those skills here. As a result, more and more of the future technology upon which the U.S. military depends will also come from outside the U.S.

4. The chronic trade deficit in goods has been financed by borrowing from overseas, indeed, from those countries, particular China, that have been running huge trade surpluses from the United States. China now holds close to two and a half trillion dollars of our IOUs. This huge debt has already constrained U.S. foreign and domestic policy and represents a huge potential weapon against us should tensions between our countries increase.

5. The potential problem of a weakening sense of loyalty to this country by the managers of hollowed-out American corporations. This is not hidden. CEOs now regularly acknowledge, even boast, that they are global, not American corporations. Take for example CEO of Cisco Systems—a major military contractor—explaining why he was expanding his R&D facilities in China: "What we are trying to do," he said, "is to outline an entire strategy of becoming a Chinese company."

   As individuals, such people may be as patriotic as the rest of the citizenry, but their jobs are to maximize profits for their global shareholders. In previous national emergencies, America could reasonably count on the support of American corporations in any confrontation with other nations. Today, it is not so clear.

The deterioration of America's industrial capacity has been evident for some time—at least since the 1970s. Despite this, the United States government still lacks any serious plan to restore the U.S. industrial base. To its credit, the Obama

Administration has taken some steps in the direction. It has stepped up to seeding of manufacturing innovation and needed public infrastructure as part of the economic stimulus. In December 2009 it published a "Framework for Revitalizing American Manufacturing." But we still lack a coherent strategy.

There many reasons for this lack of a sense of urgency. One is the claim that somehow an effort to assist a specific sector of the economy might violate our tradition of free enterprise. But even a cursory look at American history shows that aid to economic sectors deemed critical for our future was and is an American tradition. Private investment and free enterprise have always been the fundamental mechanisms through which our economy grew, but conscious government policy to assure the health of a dynamic industrial base was essential.

Alexander Hamilton's famous Report on Manufactures of 1791, calling for tariffs, subsidies, and public works to support infant American industries, was adopted by Congress in the early days of the Republic. The ideas were elaborated by Henry Clay and Abraham Lincoln and became the basis for the "American system" of economic development championed by the Republican Party during the last half of the 19th and early 20th century. Tariffs, taxes, procurement, and other policies were employed to pick industrial "winners," including clipper ships, railroads, assembly line technology, airplanes, telegraph, telephone, long distance radio, and television.

The purpose was not simply to *buy* it in America or to *invent* it in America, but to *make it in America*.

II. Industrial Policy: The Road Not Taken[1]

By the mid-1970s, cracks in the American industrial base were already visible. For the first time in the 20th century the United States began running trade deficits. Factory closings that had earlier been limited to apparel, shoes, and plastic toys spread to steel, small appliances, and auto parts. And the decision by the Arab states to control oil prices signaled that the era of cheap energy that had fueled American manufacturing was coming to an end.

These early signs of trouble set off this country's last serious debate over the question of whether the government should have a policy for supporting a healthy

[1] This section is taken from my article of the same name in the January/February 2010 issue of The American Prospect

manufacturing industry. The question was: can our government could help rebuild the manufacturing sector? For many it was a no-brainer: if our government could help Germany and Japan rebuild their industrial base, why would it not now help U.S. manufacturing to stay competitive?

Specific proposals included:

- A national development bank, inspired on the depression-era Reconstruction Finance Corporation that had provided investment funds to manufacturers when private banks were not lending.
- Tax code revisions, such as ending the favorable treatment of foreign over domestic investment, and the introduction of a "border adjustable" value-added-tax that other countries used in order to give an advantage to domestic production.
- Civilian adaptations of the Department of Defense use of procurement contracts to spur technological innovation.
- Generous government financing of technical education and training and lifetime learning to acquire and upgrade skills.

The idea of a purposeful industrial policy was also connected to a growing interest in how the nation should think about its long-term future. Toward the end of his presidency, Dwight Eisenhower had established a Commission on National Goals. John Kennedy gave the country an example of how modern goal-setting could work in his pledge to go to the moon. Richard Nixon in 1970 proposed a National Growth Policy that would guide public and private investments. Later that decade, Senators Ted Kennedy and Hubert Humphrey (Democrats) and Jacob Javits (a Republican) introduced legislation for a National Economic Policy Commission to counterbalance Washington's penchant for short-term economic fixes with a longer-term perspective. Similar bills started to make their way through the House, and the Joint Economic Committee held extensive hearings.

These concerns were not limited to Washington. Organized around the celebration of the nation's bicentennial in 1976, hundreds of state and local governments around the country sponsored citizen forums to develop plans for what their community might look like by the year 2000. Issues included energy conservation, land-use and transportation planning, poverty and equal opportunity, and—especially in declining industrial areas—the future of manufacturing.

But the democratic discussion of the future of the nation in general, and its industrial base in particular, had powerful enemies. The Republican Party had been a champion of industrial policy during America's rise as an economic and political power, but ironically those elected as “conservatives” in the 1970s, rejected that successful model.

Within the Administration, opposition was led by the chair of the Council of Economic Advisors. His objections were not economic, but ideological—what the private economy produced, whether it should have a manufacturing sector at all, was none of the public’s business.

His view reflected the postwar “neoclassical synthesis” of two strains of capitalist economic thought. One was the post-Depression *macro*-economic focus on economy-wide aggregate numbers, symbolized by the gross domestic product, that is, the dollar value of everything the economy produces. The other strain came from 19th century *micro*-economics – the modeling of how perfectly informed rational autonomous individuals maximizing short-term profits respond to price changes. The synthesis conceded to the liberals that government had a responsibility for fiscal and monetary policies to stabilize the overall economy. It conceded to the conservatives that all other decisions should be made by the unfettered market.

About the vast, messy *meta*-economy in between—where most corporate managers, workers, investors, speculators, inventors, schemers, and rent-seekers actually lived and worked—synthesis economists had nothing to say. This world could not easily be fit into the mathematical modeling that economists felt necessary in order to assert their discipline’s claim to being a science. Moreover, understanding it required tools beyond the economists’ training—engineering, psychology, politics, management, marketing, labor-relations, law, and most of all the study of how complex institutions behave and change over time.

Such an approach to economics has a distinguished American intellectual tradition reaching back to figures such as Thorsten Veblen, John R. Commons, and Adolph Berlet. But by the late 1970s their work was largely swept outside the economic policy mainstream—as were even prominent economists whose support for industrial policy came from their study of business institutions. These included John Kenneth Galbraith, whose widely read books dissecting the behavior of the modern corporation were deemed by the synthesis majority as insufficiently mathematical; Nobel prize winner Wassily Leontieff, whose pioneering “input-output” methodology analyzing the flow of resources to and from economic sectors made him seem too friendly toward planning; and Lester Thurow of MIT, who seemed too interested in studying the way businessmen actually behaved and the effect of their behavior on the distribution of income and wealth.

Over the next decade, a widening circle elaborated the case for a conscious nurturing of a high-wage road to future prosperity as an alternative to the low-wage road on which the country was traveling. Analysts at the Business Roundtable at the University of California at Berkeley insisted that we had something to learn from the Japanese. Robert Reich, a lawyer, and Ira Magaziner, a business consultant, argued that sectoral policies were essential for growth. Labor economists at the Economic Policy Institute showed how the erosion of wages from the manufacturing sector was spreading throughout the labor force. Economists Barry Bluestone and Ben Harrison wrote a book whose title, the *Deindustrialization of America,* became the iconic phrase in the policy debate.

But policy debates are rarely settled on their philosophical merits alone. To a large degree, the conflict within the policy class was a proxy for the conflict of interests among those with power and money at stake. For example, the State Department, which favored helping foreign industries to capture U.S. markets as a way to gain Cold War allies, was opposed.

More important was the hostility of the Treasury Department, which represented the interests of financiers who were against giving the government power to guide private investment in ways that would serve the interests of American *producers*, rather than America's *global investors.* America's financial elite was also aware that if manufacturing industries were to shrink, so would the political power of the strongest American unions.

The industrial policy debate consummated the marriage of Wall Street and theoretical economists that continues today. As always, a dowry helped. Wall Street firms contributed funding to friendly economics departments and think-tanks, and gave generous consultant contracts to economists to build models showing that their exotic derivatives were low-risk bargains.

On the other side of the debate, considerable support for industrial policy came from people with a more real world perspective. The Departments of Commerce, Transportation, and Labor started joint programs to help certain industries modernize to meet international competition. Supporters outside the government included the AFL-CIO, and CEO's of several industrial corporations, such as Ford, Cummins Engine, RCA, and Bendix. The editors of *Business Week* were supportive. Even a few Wall Street leaders joined up. Felix Royatyn of Lazard Freres commented that "the thought that this nation can function while writing off its basic industries is nonsense."

President Jimmy Carter himself was both a champion of private enterprise and of sensible government planning.   As a career navy officer he had been involved in long-term strategic planning, and he certainly understood the role of government in maintaining his family's peanut business. His great and tragically aborted effort to make the U.S. energy independent was in fact, industrial policy.

Had Carter won a second term, manufacturing and energy policy might have been integrated, which could have significantly changed the direction of the U.S. economy over the last 35 years. At the very least, the country would be way ahead of where it is now in the development of green industries, energy-efficient transportation, and a 21st century workforce. It would likely have a much smaller trade deficit and foreign debt burden. And having the country conscious of the importance of a healthy domestic industrial base could have prevented the Clinton Administration from later making two decisions that undermined the long-term health of the U.S. economy—the deregulation of finance that shifted growth from production to overleveraged consumer debt, and the abandonment of U.S. industry to unwinnable competition with low-wage Chinese mercantilism.

But it was not to be. Following the advice of his macro-economists, Carter went into his re-election year with back-to-back recessions and an inflation rate in double-digits. Upon becoming president, Ronald Reagan immediately ripped out the solar panels that Carter had installed in the White House. The search for energy independence was left for dead.

The end of the Cold War seemed to provide another opportunity to shape the country's industrial future. In the campaign of 1992, Bill Clinton promised government help to redirect the technological resources and talents of the military-industrial complex to work on such civilian projects as medical technology and high-speed public transportation. But, after his election, the promise was quickly abandoned. Economic policy was reduced to cheap money, tight budgets, and free trade. Seeing the writing on the wall, American manufacturers accelerated their flight to factories overseas.

But industrial policy, in the sense of government aid to specific sectors, was *hardly dead. Only the major assisted sector was not manufacturing, but finance.* Over the last two decades, the U.S. government has consistently subsidized, protected, and rescued the banking and finance sector. Among the perverse results of this "too Big To Fail" industrial policy has been the systematic redistribution of capital from the making of the products of manufacturing to the making of the products on Wall Street, i.e., speculative debt.

Today, we stand amid the ruins of that policy.

III. Needed: An Integrated Strategy

President Obama wisely has said, "We cannot rebuild this economy on the same pile of sand...We must lay a new foundation for growth and prosperity that will move us from an era of borrow-and-spend to one where we save-and-invest, where we consume less at home and send more exports abroad."

In response a number of sensible policy proposals to help manufacturing are now being discussed. They range from launching more aggressive trade and globalization policies to new investment incentives to the redevelopment of our energy and transportation sectors. These are important initiatives, which others here I believe will discuss.

My final comments concern the need for a comprehensive approach. The absence of an overall integrated economic and national security strategy has created a high-level "silo effect" where policies aimed at separate missions work against each other. For example:

- For the last 20 years, we have been subsidizing the development of Chinese mercantilism at the price of de-industrializing America, while at the same time making strategic military plans with China as a potential adversary. One can argue for one or another policy, but not both together.
- There is widespread support for more public support of research and development programs. Yet, there are no policies to assure that actual production of the new products generated will not be off-shored or licensed to be produced elsewhere for re-import back into the U.S. Without such policies, money poured into U.S. research and development is likely to be a waste of taxpayer money.
- Everyone is in favor of increasing U.S. exports. But the competitiveness problem has two parts—imports and exports. As we have steadily opened up our economy to the global market place, imports have raced ahead of exports. The resulting trade deficit has been a major cause of the dismantling of American manufacturing, yet we continue to barrel ahead with these same trade agreements and policies that have generated our huge foreign debt.

Thus, we need to pick up the thread of comprehensive, connected industrial policies that was tragically lost some 30 years ago. The questions are not simply how to help this or that economic sector be more efficient; they are about making the American economy as a whole strong enough to support both rising living standards at home and our strategic objectives abroad. It simply makes common sense that if we want policies that are sustainable over the long term, then we need to think about them for the long term.

For starters, I offer for your consideration three steps toward integrating U.S. government policies toward making our country more economically and politically secure:

1. A presidential commission on the relationship between our industrial base and our national security authorized to study and recommend policies and governmental organization changes to integrate global strategies.

2. Select Committees on Globalization in both the House and the Senate that would include members from committees dealing with taxes and trade, armed services, foreign policy, Commerce, Labor, and Transportation.

3. Relieving the Office of the U.S. Trade Representative of its cabinet rank. The USTR has become a trade agreement lobbyist, making the negotiation of new trade agreements the definition of U.S. interests in economic globalization. Rather, it should be an instrument for negotiation of trade objectives set by policy makers responsible for the long-term economic health of the American people.

The time is ripe. Polls show that majorities of American think we need to rebuild manufacturing. And business leaders are starting to speak out in support of industrial revitalization.

But this time around, we must begin by acknowledging our own history and accept that government aid and guidance for the long term health of industrial base is in the American tradition.