

Why Trump's Industrial Policy Will Fail

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President Trump appears set to press for a mixed bag of fiscal and trade policies that will likely have contradictory effects. In addition to taking pages from President Ronald Reagan's agenda to lower corporate and personal tax rates, trim government spending and deregulate business, President Trump also seems committed to pushing a version of the Democrats' 1980s "New Industrial Policy" agenda.



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The 1984 Democratic candidate for president proposed an array of tax and trade policies to mitigate the ongoing loss of middle-class jobs and income by slowing the movement of manufacturing plants to lower-wage countries around the globe, most notably to Mexico and China. [See the sidebar, "New Industrial Policy."] Similarly:

- President Trump has signaled a willingness to impose a tariff of up to 35 percent on goods imported by U.S. firms that close their domestic plants only to open new ones abroad to achieve production-cost (and profit) advantages.
- He also supports some form of the House Republicans' proposed "border-adjusted corporate tax," which would provide a significant corporate tax advantage to U.S. firms that export goods (such as Boeing), and penalize those that import goods and parts produced abroad (such as Walmart).¹

President Trump has not yet proposed adoption of the Democrats' full industrial policy agenda. However, as Democrats proposed in the 1980s, Trump has indicated his intention to use state and federal treasuries to pay firms not to close their U.S. plants and move production abroad. Even before inauguration, Trump and Vice President Pence used a \$7 million payout from the State of Indiana to persuade Carrier to cancel plans to move production of air conditioners to Mexico.⁶

The logic undergirding Trump's policy agenda appears to be primitive: The United States will prosper under federal policy "sticks" (such as import restrictions) and/or "carrots" (such as subsidies), because any reduction in U.S. imports will translate into corresponding increases in U.S. jobs, production and real income.

Although he seems to understand that the country's income and corporate tax codes badly need simplification and rate reductions, Trump may not appreciate the complexity of the domestic and global response to new and complex trade policies. When the effects of the president's

The Democrats' "New Industrial Policy" Agenda of the 1980s²

In the early 1980s, Democrats were convinced that President Reagan's economic agenda of lower tax rates, deregulation and curbs on federal spending was a proven route to continued economic decline. Indeed, under President Reagan's policy agenda, they predicted the economy would continue to "de-industrialize" as plants closed in the wake of "capital flight" abroad.

For an alternative, they looked to the postwar economic success of Japan, which was extensively credited to industrial policies orchestrated by its Ministry of International Trade and Industry (MITI). Arguing throughout the decade that the U.S. economy desperately needed detailed federal management, Democrats proposed creation of national "development banks" and "tripartite councils" of government, business and union representatives charged with devising and implementing some ill-defined national plan to allocate the country's capital. This meant that a Democratic administration would be heavily involved in "picking (industry) winners and losers" through a variety of government subsidies, tax abatements and penalties, trade restrictions and added plant-closing regulations.

President Reagan soundly defeated former Vice President Mondale in 1984, and for good reason: Even Democratic policy stalwarts recognized the flaws in their national economic management rhetoric. For example, Charles Schultze, chairman of the Council of Economic Advisers under President Jimmy Carter, observed that even old-line heavy industries could make economic transitions with greater efficiency than newly minted government bureaucracies.

Though the most extreme measures, such as nationalization, were avoided, some of the Democrats' industrial policies eventually became law, and remain with us today:³

- The 1988 Worker Adjustment and Retraining Notification Act (WARN) generally requires employers to give 60 days notice to workers and the government of plant closings that result in job losses for more than 50 workers, or layoffs of 500 or more employees.
- Another proposed measure, extension of unemployment benefits to two years, was adopted as part of the North American Free Trade Agreement in 1993.⁴
- Expanded in response to rising unemployment during the 2007-2008 recession, extended unemployment benefits have been shown to delay workers' reemployment and reduce lifetime earnings.⁵

proposed protectionist and industrial policies are scrutinized, one conclusion stands out:

- The country’s intermediate and long-term jobs base surely will not rise by nearly as much as he imagines.
- Indeed, his policy course, pursued fully and aggressively, would erode the country’s jobs base, along with aggregate real income growth.

U.S. Tariffs and Production Cost Increases. Tariffs on goods produced in Mexico, China or anywhere else will raise consumer prices in the United States proportionately.⁷ But there is also an inextricable tie between added tariffs and curbs on U.S. aggregate real income, because of the resulting increase in U.S. production costs for U.S. consumer goods compared with foreign production costs. (If production costs were not lower abroad, there would be no need to coax U.S. firms to produce in the United States through import restrictions.)

The greater production costs spurred by higher tariffs will necessarily mean more of the country’s resources will be devoted to replacing the abated imports (for example, pickup trucks). Fewer U.S. resources than otherwise will then be available to produce other goods and services for American consumers. By definition, the fewer and more expensive goods available for domestic consumption will translate into lower real incomes for Americans.

The Inextricable Tie between Exports and Imports. Trump appears to believe that Mexico (or China) sells goods to the United States for no higher purpose than to collect and bank U.S. dollars (or perhaps undermine the U.S. economy).⁸ On the contrary, Mexico’s dominant reason for selling goods to Americans is that Mexicans seek dollars to buy an array of U.S. goods and services, as well as invest in U.S. stocks and bonds, government securities, real plant and equipment, and whole firms. Exporters, such as aircraft producers, seek foreign-held dollars to expand domestic operations — which, like the exports themselves, can increase the U.S. industrial and job bases. Thus, any curb in sales of Mexican goods in the

United States will curb sales of U.S. exports to Mexico.

Trade protection will lead to employment gains in the protected industries and losses in exporting industries, because fewer dollars go to U.S. exporters. We can expect a variety of U.S. exporters from Boeing to soybean farmers to oppose any new restrictions on imports.

Higher Priced Imports, Production Inputs and Fewer U.S. Jobs. Tariffs or any other form of trade restrictions on imports will encourage employment in the protected industries, but they can be expected to drive up the costs of producers that use the taxed imports as inputs. Those firms’ final product prices will rise, undercutting their competitive market positions and reducing their sales in the United States *and* abroad below what they would otherwise be. Overall, the negative effect may partially offset some, if not all, of the job gains in the protected industries.

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For example, a tariff on imported cotton fabric produced in Mexico would increase production costs for all-cotton shirts in the United States. The remaining U.S. shirt manufacturers can be expected to raise prices, which will reduce sales. In turn, they will curb their U.S.

workforce, partially because of reduced sales but also because of the substitution of automated equipment for people to somewhat offset tariff-induced cost increases.

Similarly, a border tax on Mexican-produced and imported automotive parts would increase truck prices in the United States, undercutting any tariff-inspired employment gains from reduced U.S. imports of fully assembled vehicles. The higher prices for vehicles will feed into the production costs of a number of industries, from construction to delivery services, further spreading U.S. job losses. Tariffs on imported basic commodities such as steel have proven to have even more serious detrimental effects on domestic employment because higher imported steel prices radiate through a wide variety of U.S. industries. The losses in jobs among import-using U.S. industries would be greater than the job gains in the protected U.S. industries.⁹

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Trade Restrictions and “Rent Seeking.” Trade protections granted to some U.S. industries would inspire other industries to lobby Congress and the administration for protection of their own markets. Thus, protectionism encourages “rent seeking,” the search for profit through political, redistributive means that reduce resources available for production.¹⁰ Otherwise, higher prices for protected inputs might induce firms to relocate to lower-cost production areas of the world — *if* their own market protections are not forthcoming. In a world in which “rent seeking” for trade protections is rampant, individual worker groups *might* gain from their protections, but they will suffer from the protections for all others.¹¹

Retaliatory Trade Restrictions and the Potential for a Global Recession. Other countries harmed by Trump's trade and industrial policies can be expected to retaliate with their own “beggar-thy-neighbor” trade restrictions. China, the biggest exporter of goods to the United States and the country most threatened by U.S.-imposed tariffs may impose its own tariffs and other forms of protection on U.S. imports into China to thwart the closure of its own plants and save Chinese jobs and, thus, partially or totally negate U.S. import restrictions.

With trade restrictions begetting trade restrictions among countries, major disruptions of international trading patterns could occur, giving rise to recessions in trading countries. For example, the draconian tariffs imposed under the Smoot-Hawley Tariff Act of 1930, which were intended to mitigate the coming recession, signaled other countries worldwide to impose retaliatory trade restrictions of their own. The resulting trade disruptions only spread, deepened and lengthened the Great Depression on a global scale.¹²

The Impact of Trade Restrictions on Foreign Currency Markets. If U.S. policy measures discouraged American consumers and producers from buying Mexican-produced goods, then U.S. demand

for Mexican pesos on international money markets would decline. If this decreased demand were consequential enough to achieve Trump's significant U.S. employment goals, the dollar price of pesos would also fall, reducing the prices of a broad swath of Mexican goods, especially those not subject to the president's targeted import penalties. Cheaper prices for a Mexican good will decrease sales for a similar U.S. good, which will worsen the competitive market problems of U.S. firms.¹³ Of course, this means that employment in an array of import-competing industries could be undercut in ways the Trump administration cannot foresee.

The Survival of Profit Opportunities in the Face of Trade Restrictions. Even if penalties are imposed to discourage certain U.S. firms from taking lower-cost production opportunities they may see in

Mexico, those opportunities will not simply evaporate. They will remain available for the taking by other established firms (and newly formed investor groups) from the United States and other countries (including Mexico), which can then produce at lower costs and offer goods at lower final prices.

Penalties (or even just the threat of penalties) imposed on U.S. firms open the door for investors in unthreatened firms in the United States and abroad to reap higher returns on investment in Mexico than they otherwise would enjoy. In turn, expansion of Mexican production could erode the domestic markets of U.S. firms when Mexican firms' goods are shipped to the United States.

In addition, U.S. firms can find ways to circumvent any new U.S. trade and relocation restrictions. For instance, they could use dividend payments to disgorge themselves of earnings they would have preferred to retain and invest directly in Mexican plants. Their U.S. and foreign investors could use these dividends to form “new” domestic and foreign companies that would build plants in Mexico and in turn ship their goods to the United States. Of course, the actions of these “new” firms will undercut the production and employment gains Trump seeks.¹⁴

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Plant-Closing Prohibitions. If the Trump administration ever considers the complex interconnected effects of trade restrictions — and their likely failure — they may conclude that they can simply order U.S. firms to keep their domestic plants open where they are with prohibitive tax penalties for plant closures and relocations, as Democratic politicians and left-leaning academics tendered as far back as the late 1970s. If so, the administration is in for a rude shock.

Modern financial capital (investment funds) and much modern real capital are highly mobile because so much of it is in digital form. Digital capital often comprises crucial means of production — such as information that includes digitized books, movies, television programs and music, computer programs and data — networks of suppliers and buyers, and product designs. All forms of “digital capital” can be shipped across national borders and around the world at the speed of light and at little cost, making them elusive “quicksilver capital” that is difficult to tax and penalize.

Faced with serious challenges to control the flow of much of this modern mobile capital, Trump’s industrial policy managers could press their restrictions disproportionately on firms with relatively immobile capital — such as the steel, automobile and chemical industries. Even then, past administrations have had a tough go of preventing those industries from moving plants out of the country for more profitable venues. Moreover, in the minds of astute businesspersons and investors, any decreed restrictions (for example, constraints, fines or delays) on plant closures and relocations out of the country (and, hence, employment curbs) will inevitably convert to restrictions on U.S. plants openings for both domestic and foreign firms.

Accordingly, closure and movement restrictions will reduce investors’ expected rates of return on new or expanded investments in U.S. facilities. These anticipated lower rates of return on investments will undercut U.S. firms’ access to investment funds

in domestic and global financial markets (relative to the access their foreign competitors will enjoy). Granted, industrial-policy restrictions can have the effect of reducing U.S. trade deficits by undercutting capital inflows. However, plant closing/relocation restrictions could curb job growth in the United States while reducing firms’ competitiveness into the distant future.¹⁵ In short, any U.S. plant-closing restrictions make for plant-opening restrictions, which can inadvertently defeat the intended goal of boosting employment and incomes.

The Globalization of Trade Restrictions. If Trump were to penalize only U.S. firms that move manufacturing plants to Mexico, those firms simply could relocate to their second-best and third-best locations, say, Brazil or Vietnam, increasing imports from other parts of the world and muting the impact of the tariff on reducing Mexican imports and increasing U.S. employment. Such maneuvers that are footloose on a global scale will press the Trump administration to expand the scope of restrictive trade policies (as well as any other “new industrial policies” borrowed from the 1980s).

“Lower rates of return on investments will undercut U.S. firms’ access to financial markets relative to foreign competitors.”

Paying Firms Not to Move. Another proposed approach is to pay firms to keep their plants and jobs in this country (as with the Carrier deal in Indiana). But if the Trump administration takes that approach, it can expect that a horde of profit-hungry U.S. firms will threaten to move their plants and jobs abroad even when, absent the government payouts, they might not have considered a move. Of course, firms will seek the payouts to pad their bottom lines, but they also can seek payouts to maintain their competitive positions. Firms that receive payouts will achieve a cost and competitive market advantage that puts all other U.S. firms at a competitive disadvantage, because they will face higher tax burdens for the payoffs with no offsetting payoff for themselves. In addition, investors will understandably be partial to those firms that use whatever political and economic leverage they have to pry dollars from federal coffers, making more investible funds to the payout recipients at lower interest cost.

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Each firm seeking federal payouts may reason that its own deal will have an inconsequential impact on total federal expenditures (and budget deficits) and their taxes paid. However, if all firms (or just enough to make the economic impact of the industrial policy consequential) seek and receive the payouts, the rise in total federal expenditures will be significant. Then, the individual benefits that U.S. firms receive from their payouts can be more than offset by the taxes they must pay to cover all the payouts made to all other firms, many of which can be expected to have foreign investors.

Conclusion. President Trump's overall economic goal is to increase growth in output and well-paying jobs by making work and business more rewarding. President Reagan would be proud of that goal. But Trump would have a tough time getting President Reagan's endorsement of his tendered trade and industrial policies, which would undercut the potential economic gains from these other economic policies.

The fundamental error in Trump's proposed trade and industrial policies is his apparent belief that imports (and trade deficits) necessarily signal economic weakness. Thus, he erroneously believes that the way to restore economic greatness is to reduce imports and expand exports through restrictions on imports and "capital flight."

Business must be free to find the most cost-effective production venues, whether in Birmingham, Mexico City or Beijing. Savings in production costs by U.S. firms drive economic progress, including job growth, in the country. While Trump rails against the throttling effects of unnecessary, costly regulations on U.S. firms' competitive standing in the domestic and global economies, he also needs to recognize that restrictions on imports and plant movements have exactly the same economic effects.

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Notes

1. U.S. Congress, House Ways and Means Committee, “Built for Growth: A Better Way Forward on Tax Reform,” June 2016.
2. See Richard B. McKenzie, “Industrial Policy,” *Fortune Encyclopedia of Economics* (New York: Warner Books, 1985); Richard B. McKenzie, *Competing Visions: The Political Conflict over America’s Economic Future* (Washington, D.C.: Cato Institute, 1985).
3. Richard B. McKenzie, “The Closing of Profitable Plants; An Area for Government Restrictions?” Heritage Foundation, Backgrounder No. 191, June 17, 1982. http://s3.amazonaws.com/thf_media/1982/pdf/bg191.pdf.
4. “NAFTA-Transitional Adjustment Assistance,” U.S. Department of Labor, fact sheet, January 7, 2010.
5. Tim Worstall, “Extended Unemployment Benefits Really Did Raise the Unemployment Rate; They Still Are,” *Forbes*, January 31, 2015.
6. Ted Mann, “Carrier Will Receive \$7 Million in Tax Breaks to Keep Jobs in Indiana, Deal emerges after United Tech CEO’s pilgrimage to Trump Tower,” *Wall Street Journal*, December 2, 2016.
7. For instance, a \$1 tariff on an imported good would have two effects: It would raise the price to American consumers by varying amounts of less than \$1 (depending of the elasticities of supply and demand in the good’s market). It would lower the after-tariff price received by the foreign producer by the remaining portion of the tariff not paid by American consumers. That is, the price of the good to Americans could rise by, say, 60 cents while the price received by the foreign producer falls by 40 cents (or any other division, say, 55 cents and 45 cents). American sellers may, of course, want to pass along the full tariff to consumers via a \$1 increase in price. However, such a price increase will reduce consumption to the point that foreign producers will seek to increase their market shares by lowering the pretariff price they charge American importers.
8. One of Trump’s senior trade advisers has argued that China has orchestrated its industrial and trade policies to weaken the United States economically and thereby its relative world power position; see Peter Navarro and Greg Autry, *Death by China* (New York: Pearson FT Press, 2010).
9. Tim Worstall, “Why Steel Tariffs Won’t Save Jobs,” *Forbes*, July 19, 2014. For a review of the employment gains and losses from trade protection, see Bryan Riley, “Tariff Reform Needed to Boost the U.S. Economy,” Heritage Foundation, Backgrounder No. 2792, April 29, 2013.
10. David R. Henderson, “Rent Seeking,” *Concise Encyclopedia of Economics*, Liberty Fund, Library of Economics and Liberty.
11. The case for free trade is strongest when all industry and worker groups are treated equally, because all, then, can imagine the end-game in which everyone is protected to the detriment of everyone. Shucking everyone’s protection will mean that individual industries will lose their market protection but gain lower prices on all other goods they buy for production inputs and consumption. When industry groups believe they will gain from protection, they must be imagining that they will receive special treatment not granted all others.
12. Bob Bryan and Elena Holodny, “Trump’s New Tariff Proposal Could Put the Economy on a Path to ‘Global Recession,’” *Business Insider*, December 22, 2016. See also, “The Battle of Smoot-Hawley: A Cautionary Tale about How a Protectionist Measure Opposed by All Right-Thinking People Was Passed,” *Economist*, December 18, 2008; and Gene Epstein, “Donald Trump’s Worst Idea: Trade Barriers: New Trade Restrictions Would Decimate Global Supply Chains, Stunting Manufacturing Worldwide,” *Barron’s*, December 17, 2016.
13. Consider a change in the dollar price of a Mexican-produced good. If US\$1 buys about 20 Mexican pesos, this means that a Mexican-produced good that has a price tag of 100 pesos in Mexico will sell for \$5 (plus transportation cost) in the United

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States. A decrease in the value of the peso means that \$1 will be able to buy more than 20 pesos, say, 40. That change in the dollar price of pesos means that the Mexican-produced good selling for 100 pesos in Mexico will now cost only \$2.50 in the United States, increasing the quantity of the good demanded in the United States.

14. For example, if U.S. firms A, B and C in industry X cannot relocate their plants to Mexico because of threatened penalties (or tariffs), then unthreatened firms R, S and T in industry Y can be formed to take advantage of these unexploited profitable production opportunities and export their goods to the United States, reducing the market shares and employment of other U.S. firms in industry X. These steps will, as noted, increase production costs and final U.S. prices, and decrease the country's aggregate real incomes.
15. Richard B. McKenzie, "The Closing of Profitable Plants; An Area for Government Restrictions?" Heritage Foundation, Backgrounder No. 191, June 17, 1982; and Richard B. McKenzie, ed., *Plant Closings: Public or Private Decisions*, rev. ed. (Washington, D.C.: Cato Institute, 1984).