February 2, 2009

TO: Interested Parties

FROM: Anne Kim, Director, Economic Program, Jim Kessler, VP for Policy, and John Lageson, Trade Policy Advisor

RE: The "Buy American" Provisions in the Economic Recovery Package

As the American economy continues to deteriorate, few priorities are more critical than preserving and creating American jobs. Thus, few priorities are more critical to the future of the U.S. economy than the quick passage of the pending economic recovery package.

Nevertheless, policymakers must exercise caution over items—such as the so-called "Buy America" provisions now in the bill—that could have the opposite effect from what's intended. While these provisions are intended to achieve the goal of preserving and creating American jobs, they may ultimately do more harm than good. By restricting the use of foreign-made materials and goods, these provisions could precipitate retaliation from other countries, just when we should be working to grow our exports and increase global commerce. And it would certainly be challenged as a violation of international trade rules.

Moreover, it could put some otherwise shovel-ready projects on hold because there simply aren't enough American-made materials available. And while it would increase short-term domestic demand for some products, it would not necessarily promote the long-term, broad-based growth that the manufacturing sector needs to survive after the recovery package's dollars are long-spent. Finally, there's evidence that existing Buy American provisions aren't adequately enforced, and better policing alone could yield significant benefits.

We share in the desire to see American manufacturing succeed, grow, and create jobs. Thus, this memo describes three alternative proposals to "Buy American" that we believe would have equally potent political appeal and that would effectively encourage and promote American manufacturing without the deleterious side effects of the Buy American provisions.

"Build American"—A bonus R&D tax credit for American production

One option we propose is to provide a bonus R&D tax credit that significantly rewards companies based on the percentage of their manufacturing and production that occurs in the United States.[1] This would entice companies to conduct research here *and* produce here. It would not violate international laws and in fact would help America keep up with competitor nations that are far more generous than we are in funding and subsidizing R&D. And finally, it leverages what America does best: innovation and high end manufacturing.*

Manufacturers perform the majority of industrial R&D in the United States and are the principal beneficiaries of the R&D credit. Many of these beneficiaries are also small or medium-sized companies.[2]

Under this proposal, companies that also manufacture in the U.S. would earn an increase in the R&D credit, the amount of which would depend on the extent of their domestic production activities. The more a company produced in America, the larger the tax break. The credit could also be made refundable to help industries and companies that have been struggling in the current economy.[3]

"Invest American"—Cut taxes for repatriated overseas earnings spent on domestic investment

A number of leading economists, including progressive economists such as Robert Shapiro, argue that temporarily lowering the 35% tax rate on repatriated overseas earnings could inject billions of dollars in investment in the U.S. economy—investment that would normally remain overseas in perpetuity and be unavailable for domestic investment. Shapiro, for example, finds that when Congress temporarily lowered the tax rate for repatriated earnings as part of the American Jobs Creation Act of 2004, manufacturers brought home more than $252 billion (although these sums were repatriated without explicit provisos on how the money could be spent).[4]

Congress could temporarily lower the tax rate from 35% to 15% for repatriated earnings, *provided* they are used for investment and job creation in the United States, such as capital expenditures or increases in production capacity.† Unlike the 2004 provision, funds repatriated for other purposes—such as buying back stock or executive compensation—would be ineligible for the lower tax rate.

An additional tax break could potentially be created for jobs that are effectively repatriated because of a net increase in domestic production capacity.

"Buy American"—in China

In contrast to the United States, where consumption rates are too high and the savings rate too low, the savings rate in China is too high and the consumption rate is too low. This contributes to outsized trade imbalance between our two countries in two ways: first, Chinese producers must seek foreign markets for their products—e.g. America—because they can't sell enough at home.

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* For more details on this proposal, see *Creating Manufacturing Jobs—Here*, available at http://www.thirdway.org/modules/show/22

† This common-sense limitation was proposed and rejected during consideration of the American Job Creation Act of 2004, which lowered the tax rate on repatriated earnings to 5.25% for one year.

Second, low Chinese consumption rates make it that much more difficult for American companies to sell their products to Chinese consumers. Household consumption as a share of China's gross domestic product is only 35 percent (down from 45 percent a decade ago), whereas in the United States, two-thirds of gross domestic product is household consumption.[5]

The United States should pursue a focused diplomatic effort to boost Chinese domestic household consumption, including pressure on China to rethink its currency policies.[6] Boosting the spending of China's 1.3 billion consumers can not only boost the fortunes of American companies, it could even help pull the global economy out of its current downturn.

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Each of these ideas will promote American manufacturing within the letter and spirit of free, fair, and rules-based trade. These ideas will create American manufacturing jobs and encourage companies to do more of its production work in the United States.

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[1] National Association of Manufacturers, "ManuFACTS: R&D Tax Credit," November 2008, available at http://www.nam.org/~/media/PolicyIssueInformation/RandD/11308RnDCredit.ashx.

[2] National Association of Manufacturers, "NAM Tells House Small Business Committee R&D Tax Credit is Vital to Small Firms," Press Release, September 11, 2008, available at http://www.nam.org/NewsFromtheNAM/NAMTellseHSSmallBizCommRDTaxCredit%20Vital.aspx.

[3] The American Recovery and Reinvestment Act includes a five-year net operating loss carryover provision. If this credit is made refundable, refundability should apply to years *preceding* the last five years to avoid a double benefit.

[4] Robert J. Shapiro and Aparna Mathur, "Using What We Have to Stimulate the Economy: The Benefits of Temporary Tax Relief for U.S. Corporations to Repatriate Profits Earned by Foreign Subsidiaries," January 2009, available at http://www.sonecon.com/docs/studies/Report_on_Repatriation-Shapiro-Mathur-Jan2009.pdf. See also Allen Sinai's study, "Macroeconomic Effects of Reducing the Effective Tax Rate on Repatriated Foreign Subsidiary Earnings in a Credit- and Liquidity-Constrained Environment," Decision Economics, Inc., revised January 30, 2009, available at http://www.accf.org/publications.php?pubID=112.

[5] Li Yanping, "Policies to spur Chinese consumption needed," Bloomberg, December 27, 2008, available at http://www.chinapost.com.tw/business/asia/b-china/2008/12/27/189520/Policies-to.htm.

[6] Some economists argue that an artificially low Chinese currency contributes to sluggish household consumption in China by making imported goods more expensive. Morris Goldstein and Nicholas Lardy of the Peterson Institute for International Economics make this case in their op-ed "China's Currency Needs to Rise Further," *Financial Times*, July 22, 2008, available online at http://petersoninstitute.org/publications/opeds/oped.cfm?ResearchID=978.