The Hollow American Economy
A Clarion Call For Leadership

By Bill Waddell ~ May, 2009

We were collectively sold on the notion of a 'service economy' to replace manufacturing, and the proportion of Americans working in manufacturing has dropped from about 20% in 1982 to less than 13% now – more than 10 million manufacturing jobs gone. Factories have closed, small towns have been decimated, the national debt has exploded, and our balance of trade is deep in the red. We are in the worst economic situation we have experienced since the Great Depression. We gave manufacturing to the Chinese, and now they hold the IOU's we have written to pay for the American way of life – the way of life we used to pay for ourselves with the wealth we created through manufacturing. It is past time to call the service economy a failure.

In 1995 the Bureau of Labor Statistics (BLS) issued a report[i] analyzing the changes in jobs in the United States from 1983 to 1993. They said that the total number of jobs grew by 19.7 million. While employment grew at such a torrid pace, however, the number of manufacturing jobs dropped by 627,000. The growth occurred in service jobs, including 1.5 million more in food service. The drop in manufacturing jobs was just about offset by an increase in the number of janitors and cleaners. The report said, "*An increasing share of jobs was in high-paying jobs and required college training; but most jobs that were filled paid below-average wages and did not require a college education*." Throw in the jobs that disappeared following the economic disaster of Carter's term, and a total of one and a half million manufacturing jobs left on Reagan's watch.

During the Clinton years another 1.2 million manufacturing jobs were lost[ii] – but the number of financial service jobs exploded, and food services and hotel workers increased again. Going into the Bush Administration, the BLS predicted a trifling 89,000 manufacturing job loss.[iii] The reality was further expansion in service jobs; and 3,775,000 manufacturing jobs lost during the eight years covered by that forecast – almost 1 out of every 4[iv].

Obama is urging our "best and brightest" to go into technical, value creating work, rather than financial services, but his actions belie the words and further erosion of manufacturing seems certain. He poured billions into saving the failed financial sector and even paid bonuses with taxpayer money to keep and retain talent, declaring the financial service sector 'critical' to the economy. He fired the CEO of GM, put their Chief Financial Officer at the helm, and set a banker and an economist in charge of auto manufacturing's fate. Our 'best and brightest' are certainly bright enough to get the message - financial services still reign supreme.

The purpose of this article is not to advocate the demagoguery of the Republicans or the Democrats, of Wall Street or the labor unions. There is ample evidence to indict all of them for converting the United States from an exporting, value and wealth creating nation, to one careening recklessly toward bankruptcy. The purpose is to dispel some of the rationalizations for this unhealthy transformation of our economy; and it is to put both data and common sense on the table so reasonable people can engage in the critical discussion of how best to get our economy back on track.

A return to a manufacturing driven economy does not require backing away from free trade, or throwing public monies at the manufacturing sector. It is not a "Buy American" campaign to convince people they a have patriotic duty to subsidize high cost manufacturing. There are many American manufacturing companies out-performing their competitors from low cost countries by providing superior value to their customers. They are companies managing against the grain, however, and have found ways to overcome the legal and financial obstacles our most powerful institutions have set before them. They understand the nature of manufacturing has changed radically over the last few decades, and have made radical changes in their management processes in response. The greatest obstacle to manufacturing in the United States is a regulatory and financial structure that has not changed with them. We still control, motivate, punish and reward manufacturing based on yesterday's theories of management. We create barriers to companies seeking to emulate Toyota, exerting pressure on them to manage like the General Motors of long ago. When Washington and Wall Street compel companies to pursue management practices that cannot succeed, manufacturers take the only profitable way out and move operations out of the United States.

Tax cutting Republicans and big government Democrats have had their shots – and failed. The prosperity of the Reagan and Clinton years was artificial and unsustainable, and a return to either would only keep us on the path that led us to our current crisis. Cutting Wall Street loose and giving them sway has created a disaster. The labor unions still fighting Karl Marx' 'capital versus labor' war have long outlived any credibility or relevance. The increasingly sophisticated economic theories we hear from the academic elite have not worked. A common sense look at our economy is in order.

The Myth of Productivity

An honest discussion must begin by dispelling the notion that the manufacturing jobs have been lost due to extraordinary gains in worker productivity. That explanation for the job loss would get us off the hook if it were valid – we worked our way out of those jobs, and we are still creating as much wealth as ever - except it is not remotely true. A rambling BLS report put out in 2008[v] rationalizes the manufacturing job loss, stating, "*Productivity in manufacturing has risen by about one-third since 2000*". This statement defies common sense (at least in the manufacturing community) and is the product of very flawed math.

The idea that the average American factory employees 667 people today to do the work 1,000 people did at the beginning of the Bush years as a result of more computers, robots and good old Yankee ingenuity is nonsense. If there are only 667 workers, the big driver was outsourcing to China and other low cost countries – not productivity and technology. The BLS cannot distinguish the difference.

Said the BLS, *"Conceptually, the impact of offshoring is more pronounced in manufacturing measures than in business sector measures, provided the domestic manufacturer is purchasing the offshored goods or services as inputs. ... If a domestic computer manufacturer switches from domestic to foreign suppliers of intermediate parts such as memory chips or call center services, real manufacturing sectoral output is unchanged because the real value of the computer is unchanged. Because U.S. jobs are lost (all other things unchanged), labor productivity will rise. If the U.S. manufacturer switches most of its production to off-shore facilities, labor productivity might rise substantially."*[vi]

In other words, if the furniture factory lays off all of the people who make legs, seats and backs, and buys those parts from China, but keeps the few people who do the final chair assembly, the jobs lost to China are called "productivity". All the BLS knows is the factory made same number of chairs, but with fewer American workers. They only recognize outsourcing if the entire factory were closed and completely finished chairs were imported. Outsourcing components, while maintaining final assembly, is not rare. Transforming American factories from vertically integrated operations to final assemblers is the most common model.

Henry Ford learned he could fit five times as many automobiles into a freight car when he shipped components and assembled the cars at the destination, as he could if he shipped completely assembled cars. That principle of performing final assembly closer to the customer – especially with big or bulky products - is manufacturing 101. There are very few American manufacturers that have not replaced some of their content with Asian parts – and many have replaced the majority of their content.

GE is a final assembler of locomotives rather than the integrated manufacturer they once were. GM, Ford and Chrysler still perform final assembly in the USA even though a huge portion of the content is now made overseas. When Whirlpool bought Maytag and integrated manufacturing operations, they closed and downsized a number of plants. They assemble more appliances than ever, but outsourced the pumps, motors, wiring harnesses and other critical components. All of the people displaced by the outsourcing were written off by the BLS as productivity improvements because Whirlpool, GE and the auto makers still do final assembly in the USA, although they add less value than ever in this country.

If there were a great productivity improvement due to technology, the factory automation business should be booming, but low cost Asian labor has crippled it as well. The cost of five Chinese workers is not only less than the cost of one American; it is much lower than the cost of a robot.

There is no question that the American manufacturing worker is incredibly productive – more so than any worker in the world. But to call outsourcing our manufacturing economy "productivity" is false and misleading. We cannot address our economic situation by hiding the conversion of the better part of 10 million jobs from value creating manufacturing jobs into lower paying food service and janitorial jobs behind a myth of productivity.

The Myth of the Service Economy

The BLS has learned its lesson and now predicts a more aggressive decline in manufacturing, and a corresponding increase in service jobs[vii]. If the current 13% held, we would be adding 2 million manufacturing jobs. Instead, the outlook is for a further drop of 1.5 million. This swing of over 3.5 million jobs will correspond to continuing increases in the service sector.

The administration is urging more Americans to get college degrees so they can participate in the high end of the service economy pay scale – but this idea defies common sense. As the BLS said, "*an increasing share of jobs was in high-paying jobs and required college training; but most jobs that were filled paid below-average wages and did not require a college education.*" They are stating the obvious. There is a finite need for doctors, lawyers and professors.

People interact with college professors for four or five years out of their lives, if at all. They spend a few hours a year with doctors, and a good year is one in which they do not talk to a lawyer at all. There is no need for a greater proportion of the workforce to go into these professions. The growth without manufacturing will continue to be in low paying food service, hotel and janitorial jobs – but they will be filled with people who have to repay college loans from their food service paychecks.

Over the past twenty years there has been an explosion of financial services professionals, which is predicted to continue for the next ten years. Let's hope not. More people looking for clever ways to make money when there is less wealth being created led to our current economic debacle. When there is no money, they create it from thin air with loan and margin schemes. While Bernie Madoff will rightfully go to jail for his crimes, it can be argued that our entire economy became a grand pyramid scheme – borrowing money we didn't have to buy real estate at ridiculous prices, making money by selling it at even higher price to someone else who couldn't afford it, and on and on until we inevitably ran out of buyers and reality set in: We had far more houses at inflated prices than people who could afford to live in them and, like all pyramid schemes, the whole thing collapsed. Only this has been a government urged pyramid scheme; and the perpetrators are not going to jail – they are being made whole with even more borrowed money. And all the while, the wealth creating jobs in manufacturing continue to dwindle.

The folly of growing financial sector jobs while eroding manufacturing jobs was explained quite succinctly by Abraham Lincoln. He said, "*Capital is only the fruit of labor, and could not have existed if labor had not existed first. Labor is the superior of capital and deserves much higher consideration*."[viii] Without people making things and creating value, there is no money for the financial sector to play with. And without money to play with, they have demonstrated quite a knack for conjuring up phony money. Now we are paying the piper.

The proponents for our transition from a manufacturing economy to a service economy envisioned swapping our manufactured exports for service exports. But after more then two decades the world has shown no great demand for our academics, lawyers and other service professionals, as our trade imbalance proves. Our financial service professionals are especially unwelcome in many parts of the globe. As everyone who has called for customer service or technical support and wound up talking to someone in India knows, the middle end of the service sector has proven to be even more prone to outsourcing than manufacturing. As the dollar inevitably weakens, the only real prospect we have for exporting services lies with the resorts and amusement parks that thrive on foreign tourists.

The Half Measure of Innovation

The current business buzzword is 'innovation'. The theory is that with a steady stream of Blackberries, HDTV's and the like we can build an economic empire. The problem is that the idea of a Blackberry is absolutely worthless, while a real, working Blackberry is worth quite a bit. Value is created when the idea is converted to reality. We cannot build an economy around ideas, and let everyone else pocket most of the value that flows from those ideas.

Innovation is hardly a phenomenon of the 21st century. Perhaps the most innovative period in American history occurred in a decade or so before and after the turn of the last century. During that time, much of America experienced electric lights, cars, airplanes, telephones, radios, and an avalanche of home appliances for the first time. The difference is that the innovators became manufacturers. Thomas Edison came up with the idea of a light bulb; then spawned GE and thousands of jobs to make the light bulbs. Henry Ford's innovation of a car for the masses also created well paying jobs for the masses. We seem to think that we can create the same wealth on the back of the idea alone, without the effort and investment needed to turn the idea into reality. It has not worked. The one-two punch of innovation and manufacturing is how we built our economy, and it is the formula for re-energizing it.

Silly Economics

The academic justification for the wholesale outsourcing of manufacturing to low cost countries has been a distortion of the Theory of Comparative Advantage. The idea is that everyone in the world does what they are best at doing, overall global costs are optimized and everyone wins. So goes the theory, anyway.

It originated about 200 years ago when Robert Torrens figured out that "*in England it is very hard to produce wine, and only moderately difficult to produce cloth. In Portugal both are easy to produce. Therefore while it is cheaper to produce cloth in Portugal than England, it is cheaper still for Portugal to produce excess wine, and trade that for English cloth. Conversely England benefits from this trade because its cost for producing cloth has not changed but it can now get wine at a lower price, closer to the cost of cloth. The conclusion drawn is that each country can gain by specializing in the good that it has comparative advantage in and trading that good for the other*"[ix]

Grapes grow well in Portugal, but England has a lousy climate for a vineyard. Sheep, on the other hand, do well in England. So England should get its wine from Portugal and stick to growing its own wool. That makes sense, but the important thing is to note that Torrens' theory was rooted in natural resources. He assumed labor costs to be about equal. Our global economic theorists have taken a pretty common sense economic idea and twisted it to rationalize cheap labor.

The underlying premise was that *everyone* would make *something*. Portugal would not make both wine and cloth even if they could do both cheaper. The idea was to find the best balance of production that minimized the overall global cost of everything that was made. Torrens never envisioned having workers in third world countries make everything, while the developed economies devoted one fourth of their people to innovative thinking, while the remaining three fourths served their food and cleaned their homes.

China is not an inherently better place to make hammers, for instance, than the United States. Most raw materials required are just as readily available here as there. It is only a cheaper place. Productivity in Chinese factories is worse than the USA by a factor of at least five to ten times, and if hourly labor costs were equal, China would be a much worse place to make just about anything. Any 'comparative advantage' derived from making hammers in China is the result of their political and economic schemes that keep their people impoverished and willing to work for next to nothing.

We need to call a spade a spade and acknowledge that outsourcing manufacturing to low labor cost countries is not optimizing some logical global economic mechanism – it is simply taking advantage of poor folks. We get hammers without having to pay for the standard of living we expect for ourselves, and would have to pay for if we made the hammers ourselves.

The problem is that we will eventually have to pay the bill for this short term thinking. When we made the hammer in the USA, we might have paid somebody $5. We have it made in China and pay $1. We transfer the American worker to a janitorial or restaurant job where he makes $4 for the same amount of time it took to build the hammer. Obviously the American worker suffered because he took a 20% wage cut. But we all suffered. We paid the worker $5 and only had what could be a $1 hammer to show for it, but when the job went to China we paid him $4 and have nothing to show for it. The contribution to our overall wealth just went from 20¢ on the dollar to 0. The 20¢ was hardly a good deal, but it beats 0 any day. The solution is to get better at manufacturing in America - not to throw the only person making a contribution overboard.

This is not a revelation in economic thinking. The article that described Torren's theory said much the same thing: "*…many real world examples where comparative advantage is attainable may in fact require a trade deficit. For example, the amount of goods produced can be maximized, yet it may involve a net transfer of wealth from one country to the other …*"[x] The economists expounding on the wonders of globalized manufacturing left that part out.

Some defend outsourcing manufacturing to low cost countries based on its social benefits – it is good that we are creating jobs for those Chinese people who would otherwise be even deeper in the poverty hole. For a short interval this might have merit – but manufacturing hammers cheap for America is, at best, a short term and unsustainable economic band-aid for the low cost country. No country has ever built an economy on the basis of cheap labor.

Proof lies in Mexico's Maquiladora experience. The foreign owned factories employing cheap, Mexican labor went from few employees in the early 1980's to well over a million people, but are now back down to near pre-boom levels. Mexico is full of empty plants as the foreign – mostly American – companies left Mexico for even cheaper labor in Korea, then China; and now they are starting to pull up stakes in China to head for India, Malaysia, and Viet Nam.

China is learning Mexico's hard lesson. Providing cheap labor, by definition, means that the people are paid very little. In order for that country to evolve into a consumer economy, the people have to make more money in order to buy more things – but that means they are no longer cheap labor. And, of course, that means the foreign plant owners pack up again and move to some place where the workers have no such aspirations. The Mexican economy received a temporary boost from the Maquiladora boom, but it did not last and the Mexican economy has little to show for having been the destination of choice for the American manufacturers for a while.[xi]

Another example of the folly of the cheap labor economy is Eastern Europe. Following the collapse of the Soviet Union, the eastern countries became the cheap labor outlet for Western Europe. Twenty years later, many of these countries are not much better economically than they were under Soviet rule. Providing cheap labor for the higher cost German, French and British manufacturers did not get them ahead. It just kept the wages and buying power of their workers down.

The often corrupt leadership of these low cost countries has a track record of compounding the low wages of their people with high taxes on those low wages. The working people in China, India, and Malaysia live a tough life working for the Americans, but their leaders are doing well, and those tax revenues are what they use to buy our debt.

We have shed our manufacturing and wealth building core and are scouring the world looking for people who are in desperate shape. We take advantage of their ineffective, and often abusive, government policies until the workers want a little more, then we toss them aside. This is hardly a worthwhile use of America's capital, and a worse justification for gutting our manufacturing capability.

To add insult to injury, we allow a ridiculous imbalance in import duties to further drain our manufacturing base. Foreign goods come into the USA with a 2-4% import tax. On the other hand, the Chinese tag goods from the USA with a 10-15% import tax, and India and Brazil mark up American products by 35-40%.

Turning It Around

There are no simple solutions, but the starting points are fairly clear:

We have to have truthful, accurate information. That the BLS cannot distinguish between productivity and outsourcing is unacceptable. America's leaders and taxpayers have to know the truth, and only then can we deal with it.

Second, we need to take a long, hard look at Wall Street. The manufacturers under Wall Street's intense short term pressure are closing factories and converting Americans from factory workers to hotel and restaurant workers. Privately owned companies like Pella and Wahl Clipper, that pay scant attention to the New York financial community, and foreign owned companies such as Toyota and Honda, are doing quite well manufacturing in the USA. This is because those companies are not subject to SEC and Washington mandates that they keep their books in a manner that is utterly destructive to manufacturing. They operate more on the basis of cash – real money – and less by formulas and ratios that are so easily manipulated to drive short term stock prices.

Institutions whose goals should be to serve manufacturing companies and their investors have become institutions that serve themselves. We must make fundamental changes to fix this. Tweaking the rules or rolling back regulatory changes to the days of Reagan or Clinton will not help. We must discard the notion that the daily change in the Dow Jones Average is the most important measure of our economic health. The number of jobs in true value creation activities is a much more accurate measure of the long term health of the country. Implementing a graduated capital gains tax that punishes short term investors seeking to turn a quick profit, and rewards long term investors seeking true value would be an enormous boost to manufacturing competitiveness. Banning short selling, derivative schemes, and other practices that do nothing for companies and their serious investors would drive the financial manipulators away and keep them from destroying factories. Such changes would put pressure on CEO's to develop and implement effective long term strategies, and put an end to excessive bonuses based on near term stock price fluctuations.

Most important we need true leadership. 13% of manufacturing workers are union members. Congress cannot let organized labor speak for manufacturing when 87% of their constituency has rejected union thinking. Advocating more government - more overhead and bureaucracy - only pours gasoline on a fire that is already burning out of control. We have seen what government ownership of Conrail, Amtrak and the Post Office has led to, and manufacturing needs none of it.

Congress must get past the idea that supporting Wall Street is the same thing as supporting capitalism and free enterprise. They have to realize that Obama's promise to 'stick it to the millionaires' resonates with the average working person because the profile of the typical millionaire has changed. Where the wealthy were once the people who created businesses and created jobs, they are more and more executives who reap outrageous bonuses for closing factories and destroying jobs. And they are originators of financial shenanigans that make lots of quick money, at the expense of factories and Main Street America.

On both sides of the aisle we need leaders who can rise above the lobbyists and their money, free their minds of the narrow ideologies of the past, recognize that the unions and Wall Street are self-serving fringe groups, and listen to what Main Street manufacturing is telling them. At the end of Obama's term, we will have had 24 consecutive years of Ivy League leadership (the bastion of the failed globalization and service economy theories), who have drawn from the same small circle of thinkers to drive every major economic and financial policy. The select few voices heard in Washington are oblivious to the damage they done on Main Street; and blind to the obvious failure of their theories. The Secretary of Commerce, who should be our leading advocate for manufacturing, is an Ivy League educated career politician with no sense of America's factories at all. There is no manufacturing voice in our government at a time when we so desperately need one.

We need a full airing in America on this very critical matter. Champions must step forward to lead an effort to honestly explore how best to stop the continuing collapse of American manufacturing. Tell the globalization experts to stay at home. They have had their say. Instead ask people like Doc Hall from Indiana University who formed the Association for Manufacturing Excellence to explain the current state of manufacturing and how we got here. He is a walking encyclopedia of the last thirty years of successes and failures. Call in Brian Maskell to explain how government mandated accounting rules are eroding manufacturing, and how the privately held companies are doing accounting in a radically different way, and managing their companies much more effectively as a result. Have Jeffery Liker explain to you the real reasons for Toyota's manufacturing tap dance over General Motors.

Very important questions must be asked and answered: If manufacturing cannot compete with American wage rates, energy and healthcare costs and taxes, how do Pella, Wahl, Toyota and Honda and many others do so well manufacturing in the USA? The answer is that there is much more to it than legacy costs hung over from old labor agreements, and the excuses listed. Follow the Toyota principle of asking 'why' five times, and you will unearth some fundamental systemic problems only the government can solve.

What is the reason for the disparity between publicly and privately held companies – why do the privately held companies do so much better, and why are they less apt to outsource? What is behind the falling out at NAM (National Association of Manufacturers) – the big manufacturing lobby – between the big publicly owned companies and the smaller privately owned ones?

Can the economists explain in plain English how outsourcing manufacturing is not eroding the nation's wealth? Can they refute the warning on the dangers of applying their theory of competitive advantage when the sole advantage is the hourly labor wage? Of course they can't, which must be a clarion call for leadership.

The loudest lobbyists for the unbalanced tariffs between the USA and the cheap labor countries are the companies that have outsourced their manufacturing to those countries. It certainly is in their best interests to keep the import duties on the components they bring in from China low, but is it fair and in the best interests of the country? Again, the answer is obvious. Free trade is one thing, but we must also have fair trade.

What are they teaching at the leading business schools? If nothing else, government must stop looking to the elite schools that advocate destructive economic theories to fill every key position. If the Ivy League cannot provide people capable of leading wealth creation, hundreds of great schools in the South, the West and the Midwest can.

The MEP's (Manufacturing Extension Partnerships) are our national resource for manufacturers, yet they have to fight for funding and their very survival every time a budget is enacted. They must be backed, funded, and brought out from the basement of the National Institute for Science and Technology and moved to the forefront.

In short, we must have a full airing of every aspect of manufacturing – how it is impacted by the government, the academic community, and by management.

Conclusion

We need to rethink who our heroes really are. Jack Welch ran General Electric from 1981 to 2001, and racked up enormous profits. He is lionized as a great business leader, and his books are quoted as gospels. He retired with an $8 million a year pension. In driving GE to such meteoric heights, however, he largely transformed GE from a great manufacturing company into a finance company. More than 100,000 people lost their jobs in the USA at his direction, and he once directed a 70-70-70 policy. 70% of all GE did should be outsourced; and 70% of that should leave the USA; and 70% of that should go to India.

Now his protégé is hat in hand in Washington, taking more than $200 billion in federal bailout money and begging for a couple of massive environmental engineering contracts that may well be necessary to assure GE's survival. Another of his protégés took over The Home Depot, outsourced all he could to India, and derailed it from its long record of growth and great customer service. After taking a $210 million severance check from The Home Depot, he was hired as the head of Chrysler. Bankruptcy, federal bailouts and a sale to a foreign owner are his legacy there.

What Welch did was to turn GE from a wealth creation entity into a house of cards. The dizzying earnings of the 1990's are gone and we the people are stuck with the bill to clean up the mess he made. Yet he is still the business celebrity the media wants to interview on Sunday morning television for his business insights, and the doors to power in Washington are still open to him any time.

These people are not heroes - far from it. Our business heroes are the thousands of American men and women in who roll up their sleeves and compete toe to toe every day with the best in the world, and win – in spite their government and the financial sector. These people are committed to their communities and the people with whom they work. They – not the clever financiers – are our business heroes; and they are the key to turning our economy around and getting us back on the track we were once on. But they cannot do so without the support of the country, and we are rapidly running out of time.

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