

Testimony Before the US Joint Economic Committee

Alternatives to Tariffs to Boost US Competitiveness

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Chairman Heinrich, Vice Chair Schweikert, and members of the committee, thank you for the opportunity to discuss tariffs and better alternatives to boost US competitiveness. My name is Erica York, and I am a Senior Economist and Research Director at the Tax Foundation, a nonprofit think tank dedicated to studying tax policy at all levels of government.

The goals of boosting productivity, opportunities for workers, and US competitiveness on the global stage are all worthy. Tariffs, however, are not well-suited to meet any of those goals for the US economy. In this testimony, I will focus on three key ideas to illustrate why an alternative to tariffs is needed in the context of tax reform: the negative impact of the 2018-2019 tariffs on the US economy and manufacturing, the interconnectedness of US manufacturing with the global economy, and how moving to a consumption tax base away from an income tax base can better meet the goals of greater productivity and investment.

The 2018-2019 Trade War Tariffs Did Not Deliver Manufacturing Jobs or Higher Output

Debates about American manufacturing often focus on manufacturing jobs rather than manufacturing output and productivity. It is true that manufacturing employment has declined, but that decline follows broad global and historical trends in which workers shift from agriculture to manufacturing in early stages of development, then from manufacturing to services in later stages of development.

The US has followed this path, primarily driven by growing manufacturing productivity and by increases in consumer spending on services too. As technology advances, fewer workers are needed to produce the same quantity of goods. The result is a negative relationship between manufacturing productivity and manufacturing employment. That is why manufacturing output in the United States has continued to grow even as the share of workers in the manufacturing sector has shrunk. In other words, the blame lies not with trade or other economic policies, but with greater productivity, often through automation, and greater consumer spending on services.

One economist recently concluded that it is “difficult to imagine any policy or technological changes, short of turning back the clock on U.S. manufacturing productivity (e.g. smashing all the machines), that can bend this curve in a way that reverses the long-run decline in the U.S. employment share of manufactur-

ing.”¹ Instead of focusing on employment shares, the most relevant policy question for the manufacturing sector is what can be done to boost productivity.

Rather than boosting productivity, tariffs forfeit productivity and output to preserve jobs at firms and in industries that are relatively less productive. According to a review of the economic studies on the 2018-2019 trade war tariffs conducted by the Office of the United States Trade Representative, the tariffs in aggregate have had a small negative effect on US economic welfare and incomes, increased prices of imported goods into the United States due to nearly complete pass-through of the tariffs to US importers, decreased overall manufacturing employment, and depressed investment growth.² While imports from China fell, they were largely replaced by greater imports from countries such as Mexico, Korea, and Taiwan, resulting in no meaningful change in the overall balance of trade.

The story that plays out with tariffs is one of redistribution and reallocation. As tariffs increase the price of foreign-produced goods, they incentivize buyers to switch to domestically produced goods and provide domestic producers room to increase their prices. Domestic producers benefit from higher prices and sales, but their benefit comes at the expense of other people and businesses in the domestic economy. For this reason, tariffs are redistributive, taking income from some and giving it to protected businesses and pulling resources from where they are productively employed and reallocating them to less efficient producers. While tariffs create benefits for protected industries, higher input costs and retaliatory tariffs fully offset the benefits of protection, resulting in net losses in production and employment in the US economy overall.³

The United States International Trade Commission (USITC) found a similar outcome in an industry-level analysis of the tariffs on steel and aluminum, estimating an average of \$2.8 billion in production increases enabled by the higher prices from the tariffs but a larger \$3.4 billion in production decreases in certain downstream industries, like construction and equipment manufacturers, that rely on steel and aluminum as inputs.⁴

The decline in the share of workers employed in the manufacturing sector has continued apace with tariffs (largely retained, and in some cases increased, by President Biden) as well as with new US subsidies for certain manufacturers under the Biden administration.⁵ We should expect a similar reallocative effect from protectionist subsidies as we expect from protectionist tariffs: tax cuts aimed at narrow subcategories mostly shift investment to that sector, instead of driving aggregate investment growth. While it remains too soon to tell how this reallocation of investment will affect overall productivity growth, we have plenty of reasons to be pessimistic that it will prove successful.⁶

1 Kyle Handley, “What happened to U.S. manufacturing?,” Economic Innovation Group, July 2024, <https://eig.org/wp-content/uploads/2024/07/TAWP-Handley.pdf>.

2 US Trade Representative, “FOUR-YEAR REVIEW OF ACTIONS TAKEN IN THE SECTION 301 INVESTIGATION: CHINA’S ACTS, POLICIES, AND PRACTICES RELATED TO TECHNOLOGY TRANSFER, INTELLECTUAL PROPERTY, AND INNOVATION,” May 14, 2024, <https://ustr.gov/about-us/policy-offices/press-office/press-releases/2024/september/ustr-finalizes-action-china-tariffs-following-statutory-four-year-review>.

3 Aaron Flaen and Justin Pierce, “Disentangling the Effects of the 2018-2019 Tariffs on a Globally Connected U.S. Manufacturing Sector,” Finance and Economics Discussion Series 2019-086, Washington: Board of Governors of the Federal Reserve System, December 2019, <https://doi.org/10.17016/FEDS.2019.086>.

4 United States International Trade Commission, “Economic Impact of Section 232 and 301 Tariffs on U.S. Industries,” March 2023, https://www.usitc.gov/publications/332/pub5405.pdf?source=govdelivery&utm_medium=email&utm_source=govdelivery.

5 Martin Wolf, “Manufacturing fetishism is destined to fail,” *Financial Times*, Nov. 12, 2024, <https://www.ft.com/content/ae57e7f-62f1-4a57-a780-341475cd8f89>.

6 Alex Muresianu, Alex Durante, and Erica York, “Leveraging Tax Policy to Bolster US Economic Growth Amid Competition with China,” Tax Foundation, Oct. 9, 2024, <https://taxfoundation.org/research/all/federal/us-chinese-economy-investment-manufacturing/>.

Most US Imports Are Intermediate and Capital Goods Purchased by US Producers

Doubling down on broad-based tariffs is particularly problematic given the interconnected nature of US trade relationships today.

The United States is the largest goods importer in the world. In 2023, the US imported \$3.1 trillion worth of goods, and about half of those imports were industrial supplies and materials or capital goods.⁷

US manufacturers rely on a complex web of global relationships and value chains to source parts, materials, and equipment in order to produce and create jobs in the United States. From 1997 through 2017, multinational firms accounted for 65 percent of US goods exports and 60 percent of US goods imports, on average.⁸ In 2022, 33.7 percent of US exports and 46.6 percent of US imports constituted within-firm trade, or trade between a parent firm and an affiliate or related party.⁹

Placing tariffs on imported inputs does not boost global competitiveness, but instead directly increases the cost of operating in the United States and makes it harder for US-based firms to compete. A new study from the New York Fed concludes “extracting gains from imposing tariffs is difficult because global supply chains are complex and foreign countries retaliate.”¹⁰

Indeed, in the most recent round of tariffs, firms that eventually faced tariff increases on their imports accounted for 84 percent of all exports and represented 65 percent of manufacturing employment. For all affected firms, the implied cost was \$900 per worker in new duties, or the equivalent of placing a tariff on US exports of 2 percent for the typical firm and 4 percent for products with higher exposure to tariffs.¹¹

Imports and exports are highly interconnected. Import tariffs can hurt exporters by raising production costs, reallocating resources away from export industries, causing currency appreciation, or inviting foreign retaliation.¹²

The United States is currently the second largest goods exporter in the world overall; for instance, the US leads the world in aerospace exports and is the second largest auto exporter.¹³ US manufacturing value-added is the second largest in the world, larger than the manufacturing value-added of the next three nations—Japan, Germany, and India—combined.¹⁴ And value-added per worker far outpaces any other nation, revealing the global dominance of US manufacturing productivity.¹⁵

7 US Bureau of Economic Analysis, “Table 2.1. U.S. International Trade in Goods,” accessed Dec. 10, 2024, https://apps.bea.gov/iTable/?ReqID=62&step=1&_gl=1*ig-9jo2*_ga*MzlyNjY5MjcZLjE3MzM1MTQyODM.*_ga_J4698JNNFT*MTczMzg0NjYxNS4zLjEuMTczMzg0NjYzMS40NC4wLjA.#eyJhcHBpZC16NjlslnN0ZXBzLjpbMSwylDYsNI0slmRhdGEiOltbIlByb2R1Y3QiLC1xIl0sWyJUWYwJsZUxpc3QiLC10NSJdLFsiRmlsdGVyXyMxliXbljliXV0sWyJGaWw0ZXJfIzIiLFsiMCJdXSBkZpbHRI-cl8jMylsWylwll1dLFsiRmlsdGVyXyM0liXbljAiXV0sWyJGaWw0ZXJfIzIiLFsiMCJdXSV19.

8 White House, “Economic Report of the President,” March 2024, <https://www.whitehouse.gov/wp-content/uploads/2024/03/ERP-2024-CHAPTER-5.pdf>.

9 Ibid.

10 Mary Amity, Matthieu Gomez, Sang Hoon Kong, and David E. Weinstein, “Do Import Tariffs Protect U.S. Firms?,” *Liberty Street Economics*, Dec. 5, 2024, <https://libertystreeteconomics.newyorkfed.org/2024/12/do-import-tariffs-protect-u-s-firms/>.

11 Kyle Handley, Fariha Kamal, and Ryan Monarch, “Rising Imports Tariffs, Falling Export Growth: When Modern Supply Chains Meet Old-Style Protectionism,” *International Finance Discussion Papers* 1270, February 2020, <https://doi.org/10.17016/IFDP.2020.1270>.

12 Erica York and Nicolo Pastrone, “How Do Import Tariffs Affect Exports?,” Tax Foundation, Aug. 28, 2024, <https://taxfoundation.org/blog/import-tariffs-affect-exports/>.

13 Statista, “Leading countries with the highest aerospace exports in 2023,” <https://www.statista.com/statistics/263290/aerospace-industry-revenue-breakdown/>; International Organization of Motor Vehicle Manufacturers, “2021 Production Statistics,” <https://www.oica.net/category/production-statistics/2021-statistics/>.

14 World Bank, “Manufacturing, value added (current US\$),” World Bank national accounts data, and OECD National Accounts data files, https://data.worldbank.org/indicator/NV.IND.MANF.CD?end=2022&most_recent_value_desc=true.

15 Colin Grabow, “The Reality of American “Deindustrialization,” *Cato Institute*, Oct. 24, 2023, <https://www.cato.org/publications/reality-american-deindustrialization>.

US dominance, however, is not guaranteed to continue if the US does not continue to reinvest and grow. A tax reform strategy that prioritizes incentives for investment and growth, rather than a tariff strategy that reallocates investment and reduces productivity, is needed.

Removing the Tax System's Bias Against Production Supports All Businesses, Including Manufacturing

Many members of Congress may be concerned about the way our trading partners tax goods and services that cross the border. All other nations in the Organisation for Economic Co-operation and Development (OECD) levy a national-level value-added tax (VAT), but the United States, with no VAT, remains an outlier in the world.¹⁶

VATs are border-adjusted, meaning they rebate tax on exports and impose tax on imports, while the income tax system in the United States is origin-based, meaning it taxes all domestic production, even production for export.¹⁷ Despite the appearance of subsidizing exports, however, a border-adjusted VAT is trade neutral. A border adjustment would allow producers to reduce the prices they charge overseas. In turn, demand for dollars would rise to purchase those goods, increasing the value of the dollar relative to foreign currencies and offsetting any perceived trade advantage.¹⁸ Thus, adopting a VAT, or any other form of consumption tax, will not permanently boost exports and reduce imports. Ultimately, a border-adjusted tax falls equally on goods consumed within a country, whether the goods were produced domestically or imported; exports are exempt because they are not consumed within a country.

The economic and administrative case for moving to a consumption tax base does not rest on an argument about boosting exports but instead is based on boosting investment and capital accumulation by removing income tax biases and simplifying the complexities of the current income tax system.

Income taxes apply when taxpayers earn money and when they see changes in their net worth, such as returns from saving and investment. Changes in net worth, however, usually become consumption later. That's because income is either consumed immediately when it is earned or, if consumption is deferred by saving, income is consumed in the future after it has been saved.

As such, an income tax system double taxes or places a higher tax burden on future or deferred consumption. Because of that, income taxes create a tax penalty on saving and investment, depressing levels of capital accumulation, productivity, and output. Taxing income also requires complicated determinations on how to define income, which increases the complexity of the tax code and results in billions of hours of lost productivity each year.

In contrast, a consumption tax only taxes income once, whether it is consumed right away or saved and consumed in the future. A consumption tax base removes the tax penalty on saving and investment created by an income tax. Removing that tax penalty means people save and invest more, resulting in higher

16 Daniel Bunn, Cristina Enache, and Ulrik Boesen, "Consumption Tax Policies in OECD Countries," Tax Foundation, Jan. 26, 2021, <https://taxfoundation.org/research/all/global/consumption-tax-policies/>.

17 Alan D. Viard, "Border Tax Adjustments Won't Stimulate Exports," American Enterprise Institute, Mar. 2, 2009, <https://www.aei.org/articles/border-tax-adjustments-wont-stimulate-exports/>.

18 Kyle Pomerleau and Stephen J. Entin, "The House GOP's Destination-Based Cash Flow Tax, Explained," Tax Foundation, Jun. 30, 2016, <https://taxfoundation.org/blog/destination-based-cash-flow-tax-explained/>.

capital accumulation, productivity, and output. That is why a long academic literature has found consumption taxes to be maximally economically efficient and simpler to administer.¹⁹

The four primary approaches to taxing consumption are the retail sales tax, the value-added tax, the Hall-Rabushka flat tax or Bradford X tax, and the consumed-income tax. While each design is different, all four approaches achieve neutral tax treatment between saving and consumption.²⁰

An alternative to tariffs that follows consumption tax principles and would succeed in boosting productivity, opportunities for workers, and US competitiveness would be an earlier version of the 2017 tax law prior to its passage—the destination-based cash flow tax (DBCFT). Despite significant improvements made by the 2017 Tax Cuts and Jobs Act, the US maintains an origin-based income tax system that places a disproportionate burden on saving, investing, and producing in the United States. The result is a tax system that depresses the levels of investment, capital accumulation, worker productivity and wages, and saving compared to a consumption tax system. The US tax system is also still plagued by complexity, with multiple provisions designed around cross-border transactions and limiting profit shifting.

While similar to a VAT, a DBCFT differs in one major respect by allowing firms to deduct payroll expenses, giving it a different tax base. A DBCFT would entail three primary reforms to our current business tax system.

A DBCFT would reform the base of business income taxes by permitting businesses to immediately deduct costs for capital and research and development (R&D) investments and eliminating interest deductions for nonfinancial firms. And a DBCFT would border-adjust the resulting cash flow tax: the cost of goods purchased from foreign sellers (imports) would not be deductible and the revenue from sales to customers abroad (exports) would not be taxable.

Adopting a DBCFT would directly confront the problems that remain with the current US income tax system and achieve the goals of higher productivity, more opportunities for workers, and a competitive advantage for US businesses that tariffs cannot.

The border adjustment would also address the problems of profit shifting and burdening domestic production—a DBCFT would impose no penalty on firms for being a US tax resident and would be neutral toward trade.²¹ By ignoring the transactions firms use to shift profits, a DBCFT would virtually eliminate the problem of profit shifting. As in the case of a VAT, a border-adjusted business cash flow tax would not permanently alter the balance between imports and exports because of its offsetting effects on currency values.

As previous Tax Foundation research explains,²² applying the tax to imports increases their cost. As Amer-

19 Anthony Atkinson and Joseph Stiglitz, “The design of tax structure: Direct versus indirect taxation,” *Journal of Public Economics* 6 (1976): 55-75; Louis Kaplow, “On the undesirability of commodity taxation even when income taxation is not optimal,” *Journal of Public Economics* 90 (2006): 1235-1250; Joseph Bankman and David Weisbach, “The Superiority of an Ideal Consumption Tax over an Ideal Income Tax,” *Stanford Law Review* 58 (2005): 1413-1456.

20 For a detailed discussion on the different approaches to consumption taxation, see Erica York, Garrett Watson, Alex Durante, and Huaqun Li, “How Taxing Consumption Would Improve Long-Term Opportunity and Well-Being for Families and Children,” Tax Foundation, Oct. 12, 2023, <https://taxfoundation.org/research/all/federal/us-consumption-tax-vs-income-tax/>.

21 Alan J. Auerbach, “Demystifying the Destination-Based Cash-Flow Tax,” University of California, Berkeley, Sep. 22, 2017, <https://eml.berkeley.edu/~auerbach/Demystifying%20the%20DBCFT%209%2022%2017.pdf>.

22 Kyle Pomerleau, “Exchange Rates and the Border Adjustment,” Tax Foundation, Dec. 15, 2016, <https://taxfoundation.org/blog/exchange-rates-and-border-adjustment/>.

icans demand fewer imports, they exchange fewer dollars, pushing up the value of the dollar relative to other currencies. Exempting exports from the tax allows US producers to drop their prices in foreign markets, increasing demand for US exports and dollars, which also increases the value of the dollar. Together, the currency appreciation from the border adjustment offsets any impact on trade.

Thus the economic case for the DBCFT is the same as for other consumption taxes: full expensing of capital investment would encourage capital formation and is one of the most cost-effective tax reforms available to boost investment,²³ and eliminating interest deductibility would place firm financing decisions on equal ground.²⁴ Removing the income tax biases against investment by adopting a DBCFT would lead to higher capital accumulation, productivity, and output.

Conclusion

In conclusion, while tariffs are often presented as tools to enhance US competitiveness, a long history of evidence and recent experience shows they lead to increased costs for consumers and unprotected producers and harmful retaliation, which outweighs the benefits afforded to protected industries. As an alternative, reforms such as a DBCFT present a more promising path to achieving higher productivity, better opportunities for workers, and enhanced global competitiveness. By addressing remaining tax biases against investment and production, and creating a neutral framework for trade, a DBCFT would foster broad economic growth.

Thank you for having me, and I look forward to your questions.

23 Gabriel Chodorow-Reich, Owen M. Zidar, and Eric Zwick, "Lessons from the Biggest Business Tax Cut in US History," *Journal of Economic Perspectives* 38:3 (2024): 61–88, <https://www.aeaweb.org/articles?id=10.1257/jep.38.3.61>.

24 Garrett Watson, "Unequal Tax Treatment Is Contributing to Rising Debt Levels for Entrepreneurs," Tax Foundation, Dec. 13, 2018, <https://taxfoundation.org/blog/unequal-tax-treatment-entrepreneurs/>.