Panel IV: Competitiveness of U.S. Industries

PROFESSOR KOH: The principal speaker for our fourth panel is Professor Gary Hufbauer of Georgetown University where he is the Marcus Wallenberg Professor of International Financial Diplomacy. He is a graduate of Harvard University and has a Ph.D. from King's College, Cambridge, as well as a J.D. from Georgetown. He's been Director of the International Tax Staff at the Treasury Department. During the Carter Administration from 1977-1980, he was responsible for trade policy as Deputy Assistant Secretary of the Treasury Department.

PROFESSOR GARY HUFBAUER: Turning to trade issues, there are two distinct problems facing the United States. First, there is the trade imbalance problem, with the prospect of U.S. trade deficits exceeding $150 billion for years to come. Second, there is the competitive problem which I define as the loss of U.S. technical leadership, especially to Japan, and the slow rate of productivity growth throughout the U.S. economy.

The macroeconomic measures required to cure the trade deficit—much smaller federal budget deficits, much larger private savings, and a lower dollar in the foreign exchange markets—will not appreciably change the competitive outlook. Conversely, steps to improve the U.S. competitive posture will have little impact on the trade deficit. Therein lies the fundamental error in Representative Gephardt's approach: an attempt to link two problems which are distinct and separate phenomena.

Let me amplify for a moment on the measures required for correction of the trade deficit. First, correction requires a substantial further depreciation of the dollar, on the order of 15% from present levels of 1.80 deutsche marks and 1.50 yen to the dollar. Second, it requires a large tax increase, for example a 4% value added tax, phased in over a period of years, and ultimately collecting about $100 billion annually. At the same time, the growth of federal expenditures must be severely limited. The alternative to these prescriptions for fiscal responsibility is to follow policies that facilitate U.S. price inflation, while encouraging wage restraint so that U.S. business savings can rise by about $100 billion annually. Like the fiscal responsibility scenario, the business saving scenario may well entail a recession. Whether or not we have a recession, a solution to
the U.S. trade deficit will require some slowdown in the U.S. economy and some pickup in the European and Japanese economies. Broadly speaking, then, the answer to the trade deficit lies in macroeconomic variables—exchange rates, fiscal deficits, and levels of economic activity.

By contrast, answers to the competitive problem must be drawn from a menu of long-term structural responses. These can be divided into three broad categories: (1) general measures to improve labor quality, promote investment, and enhance research and development; (2) targeted measures to encourage so-called sunrise industries; and (3) targeted measures to help downsize sunset industries.

The first group of responses, namely general measures, largely entails on-budget expenditures. By contrast, the second two groups—targeted measures for sunrise industries and targeted measures for sunset industries—can often be pursued in an off-budget fashion. As a rule, off-budget measures are highly inefficient, and favor many unintended beneficiaries. Let me throw out just a few quick figures. In the United States today, thanks to off-budget import protection, we transfer approximately $65 billion annually from consumers to producers. Of that amount, about $5-10 billion goes to foreign producers in the form of “quota rents.” You can never imagine Congress voting to give $1 billion of taxpayers’ money to Toyota. But the Reagan Administration and Congress, acting in concert, boosted Toyota’s profits by that much annually over several years by restraining competition in the U.S. auto market. In a similar way, off-budget protection of sugar confers, I was told, about $40 million annually on the largest cane producer in Florida. Congress would never pay that producer $40 million of appropriated money. In other words, our political system favors off-budget programs despite their grotesque characteristics. This is particularly true of targeted measures to assist particular industries.

Let me return to general measures that enhance economic performance. These measures are well known and expensive. They include measures to upgrade the deplorable quality of primary and secondary education in many of our schools. They include meaningful measures to retrain the existing labor force. Under the Job Training Partnership Act,1 our nation spends less than $250 million annually, a truly trivial sum given the magnitude of the retraining

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problem. But a worthwhile program—along the lines of what Germany or Sweden does—could easily cost $10-15 billion.

We need to undo part of what was done in the Tax Reform Act of 1986. In particular, we should restore the investment tax credit for equipment expenditures. Again, this is expensive, perhaps $15-20 billion. And we need measures to foster civilian R&D. In this country, some people still comfort themselves that U.S. R&D is high as a percent of gross national product. But that includes a lot of military R&D. I am among those who think that the latest generation of military R&D has a modest spinoff for the rest of the economy. As for civilian R&D, we are now below Japan in expenditures as a percent of GNP.

I would emphasize that general measures are the right way to go when our nation gets serious about improving its competitiveness. But unfortunately, they cost money: $50 billion annually would not be an outlandish figure.

Let me now turn to targeted measures designed to assist sunrise industries. Such measures have sex appeal—otherwise, why would commentators Robert Reich and Lester Thurow get published in the *New York Times* and other journals?

There are two major ways to assist the sunrise sector of the economy. The first is to pick winning industries and to favor those industries with easy credits, loan guarantee programs, tax holidays, antitrust holidays, “buy American” provisions, and so forth. We've done some of those things but we could certainly do much more. The obvious difficulty with such measures is the problem of bureaucratic fallibility. Who knows what tomorrow's sunrise industry will be? Won't political pressures converge on picking losers rather than picking winners?

A second variant of the sunrise assistance program is to identify “national champion firms” and to favor them with the same array of benefits. While superficially similar, the business of picking national champion firms is very different from the business of picking winning industries. Take the case of semiconductors; the current U.S. winners are IBM, AT&T, and Texas Instruments. Providing selective support to those firms is very different from providing support to the entire semiconductor industry.

The national champion firm approach has a decidedly un-American flavor. Its great virtue is that it concentrates resources on estab-

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lished centers of business excellence; its great vice is that it favors those who are already on top. The national champion firm approach may well be un-American, but it is followed elsewhere. I believe that it is practiced not only by Japan but also by successful European countries such as Sweden and Switzerland.

I now turn to targeted measures designed to assist sunset industries, particularly those affected by import competition. The problem here is that worthwhile measures to ease the adjustment burdens faced by sunset industries are not the least sexy. The challenge to Congress and the President is to take worthwhile approaches that have no sex appeal and turn them into workable policies.

Let me briefly outline what the United States has done recently for losing industries, because it's an uninspiring story. For the most part, policy begins and ends with trade protection. In the years since 1980, the Congress has gotten itself a reputation for protectionism mainly through congressional rhetoric. But, in fact, far more protection has been imposed by the Administration than by Congress. In 1980, the percentage of imports that were subject to "special protection"—that is, extraordinary protection—was about 12%. That figure is now up to about 20%. The cost to consumers of special protection is running at about $65 billion annually. This includes the cost of trade-restraining measures such as the Multi-fiber Arrangement, the look-alike steel cartel, restraints on dairy and sugar imports, and others.

For the most part, it is the Reagan Administration that has burdened the American people with this foolishness. But in fairness to the Administration, its pro-free-trade rhetoric has been great. The Administration has been forced by political necessity, in light of the macroeconomic context, to impose trade restraints that it probably didn't like—such as the recent semiconductor arrangement, the restraints on Canadian softwood lumber, and restraints on machine tools, all within the last year.

A much better approach than trade protection is to design acceptable ways to downsize these industries, using public funds to retrain and relocate workers. Public funds could be raised by changing the form of protection now given through quotas, and instead giving the same degree of protection in the form of tariffs. By earmarking the tariffs, funds would be available for restructuring the industry.

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Incidentally, it is far easier to pick losers than to pick winners because losers identify themselves whenever they seek trade protection. The textile and apparel industry, for example, has proven itself a loser since 1957 when President Eisenhower first gave it relief against cotton textile imports from Japan. The industry has constantly lost ground against the tide of world competition for 30 years.

Let me quickly finish by saying that the approach that we adopt for addressing America's competitiveness problem will largely depend on the paradigm that most appeals to the President elected in 1988. There are three main contenders:

First, there is the old-fashioned, liberal paradigm of an open, rule-based, multilateral economic system. This paradigm says, "Don't get involved in industry location questions and don't rock the broader security alliance by using overly aggressive economic tactics against Europe and Japan." The liberal paradigm points to general policies to revive U.S. competitiveness, and it suggests targeted measures to downsize uncompetitive industries. It certainly eschews industrial policies for sunrise industries. I prefer the liberal paradigm, but I'm afraid it's losing ground in Washington and in the country at large.

Second, there is the paradigm of America as Rome. This paradigm emphasizes that continued U.S. leadership in the world of security affairs depends on the United States remaining the home of the strongest corporations and the best technology. This paradigm accordingly points to targeted measures to assist sunrise firms. The paradigm challenges us to examine the definition of corporate nationality. Selected "foreign" firms—Northern Telecom and Honda are cases in point—are moving their centers of gravity to the United States. At what point will they be considered "American" firms for purposes of assessing the U.S. position in the world industrial landscape?

Third, there is the paradigm of America as Japan—an inward-looking paradigm often associated with Representative Richard Gephardt. Under this paradigm, homegrown is best. Nearly every industry is eligible for targeted assistance measures. However impossible economically, that's the goal in political terms.

To conclude, those are the three paradigms that the next President and the American people will choose from in years ahead.
Panel IV: Respondents

PROFESSOR KOH: Our first discussee is Senator John Chafee, Republican Senator from Rhode Island. He went to Yale College and Harvard Law School. He served as Secretary of the Navy and then as Governor of Rhode Island. He has now served two terms as Senator, and is the Chairman of the Competitiveness Caucus, which gives him unique perspective on the subject.

SENATOR JOHN CHAFEE: First, I agree completely with the point Professor Hufbauer made that the cures for the trade deficit won’t change our competitive position, and changing our competitive position won’t necessarily cure the trade deficit. My biggest problem with the presentation that Professor Hufbauer made was that it seemed to me that he slid over the federal deficit. Now maybe suggesting we need tax increases is a suggestion to get rid of the federal deficit, but in all of the testimony we had in the Finance Committee before getting into the trade bill, everybody—economists, prior negotiators, special trade representatives—said that the federal deficit is the biggest single cause of the trade deficit. Until we seriously wrestle with the federal deficit, we’re not going to solve the problems of the trade deficit, although obviously some improvements can be made on the fringes.

What can we do to help our industries? There was some implied criticism of the tax bill that we adopted last year, that to help our industries we want to go back to tax incentives or what we call tax expenditures. I just don’t think that’s the way to go. I think that we went a far better route with the tax bill in eliminating those tax expenditures which included the investment tax credit, one of the major savings measures that permitted us to reduce the corporate rates. I believe that the best route is the route we followed, which was to get the rates down as far as we could and then let the industries decide what to spend their tax savings on, possibly R&D or new equipment. The investment tax credit looks like a great winner to make us more competitive but it wasn’t solely directed toward exporting companies. It went to everybody. Your local dry cleaner, for example, installed some new equipment and got an investment tax credit on it. I don’t think that improved our competitive position one iota. I want to cite for you some statistics as to what these tax expenditure incentives cost us. In 1970 we would collect $2.88 of income taxes for every $1.00 of tax expenditure. In 1985, taxes had dropped to $.98 for every $1.00 of tax expenditure. In other words, the tax expenditures had gone out of sight. Had that im-
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proved our competitive position? I don’t think so, because in order to pay for it we had to have higher tax rates. We did keep some incentives. We weren’t pure; nothing Congress ever does is pure. We kept the R&D tax credit, not at 25%, but at 20%, which is nonetheless an incentive.

There has been some discussion of the sunrise industries and the government trying to pick winners. The suggestion was that we can’t pick the industries but ought to be able to pick the winning companies within the industries. If we had so many people around who could pick the winners, we’d have a lot of very rich speculators in this country. The truth of the matter is that no one can pick the winners, and the government is leery of trying to choose. Get the taxes down, encourage capital investments to the degree we can, and then let the cards fall where they may.

I couldn’t agree more on the failure of protectionism for specific industries. I have here the Congressional Budget Office (CBO) report from last November which goes into four industries: footwear, textile and apparel, steel, and oil, and CBO concludes that the very costly protection for those four industries plainly hasn’t worked. The suggestion was made that Congress talks a lot about protectionism but doesn’t do anything about it, and so it is the naughty Administration that is always kicking up the import tariffs. I don’t know the statistics, but the greatest bulwark against protectionism is clearly the President’s position. He has forestalled far greater protectionism by taking some relatively minor steps, and, most of all, by vetoing the major textile bill that was passed last year. What are we going to do about competitiveness? I think if we took the best from both proposals before the conference, we’d really have a darn good trade bill. I think that bill would be helpful, not to the degree that the proponents suggest of eliminating a $170 billion trade deficit, but perhaps by $10-20 billion. There are some other things in the trade bill that would be helpful to us, such as some clarification in the Foreign Corrupt Practices Act4 and changes in the export control.

Despite all that’s going on, the country seems to be very prosperous. Last year the federal deficit was $221 billion, and this year it will be $157 billion. There is probably a great tendency in this group to kick around Gramm-Rudman-Hollings, but it’s the only show in town that seems to be forcing us to bring deficits down. If

we can keep deficits on a downward slide I think that will continue
the confidence that has fueled this tremendous boom we're cur-
rently experiencing, the longest boom we've had since the end of
World War II. If the deficits keep coming down, it will inevitably
improve our competitive position because it is the single best thing
we can do to reduce the trade deficit.

PROFESSOR KOH: Our next speaker, representing the executive branch
and hopefully bolstered by Senator Chafee's vote of confidence, is James P.
Moore, Jr., a graduate of Rutgers and the University of Pittsburgh. After
serving on congressional staffs, he served as the Deputy Assistant Secretary of
Commerce for Trade Information and Analysis in this Administration, and is
currently the principal Deputy Assistant Secretary of Commerce for Interna-
tional Economic Policy, serving as one of our delegates to the Uruguay Round.

JAMES P. MOORE, JR.: Let me approach this from a little dif-
ferent perspective. When dealing with the issue of competitiveness,
the United States and the world marketplace are inextricably linked.
Now, after today, that is probably the most obvious and simplistic
statement that I could possibly make to this audience. But you have
no idea how difficult it is, sitting in Washington, to translate that
fundamental fact of our economy to government officials, business
leaders, and even law professors. Having said that, I think it is
im-portant to recognize that our past provides an unmistakable key to
our future.

What a difference 40 years makes! When the United States
emerged from World War II, there simply was no other country that
could competitively touch us. Markets actually came to us; we did
not go to them.

It's wonderful to read retrospectives these days about how Dou-
glas MacArthur put into motion in Japan the kind of machinery we
are facing today. Looking across the Atlantic, it is incredible to lis-
ten to Vernon Walters, our Ambassador to the United Nations, talk
about the day he literally watched a forklift deliver the first machine
tools to Germany. Today we have in place a voluntary restraint
agreement on the importation of German machine tools. We have
come a long way.

In other areas we watched, over a period of 40 years, the multi-
national corporation evolve and take center stage. For the first time
U.S. companies in a dramatic way were actually sourcing their goods
and services from foreign bases.

And then there is the textile industry, the first U.S. manufacturing
sector to be targeted for—dare I say it—protection. It was, of
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course, in the late 50s and the early 60s that the United States and other industrialized countries confronted an upsurge in textile imports from the developing world. Consequently, a multifiber arrangement was put into place that was intended to last for a period of five years protecting only one area of textiles, namely cotton. But five years turned into 10 years, and then 15 years, and then 20 years. During this period, wool was added, and since its renewal last year the multifiber agreement covers linen, ramie, and silk.

Can you believe that at this moment the textile industry has one of the lowest unemployment rates of any industry in the United States? True, the industry is considerably smaller than it was in the 60s and 70s. But the fact remains that several thousand jobs have been added to the industry over the past 18 months, and some $2 billion in research and development has been invested towards its future, making it the most technologically advanced in the world. The question is—where do we go from here? But that’s another issue.

The advent of the 1980s brought U.S. problems into focus as never before. Foreign targeting of the U.S. market has become a fact of life. In the largest and richest marketplace in the world, it was only a matter of time until any number of foreign countries targeted this consumer mecca.

In turn, the dollar took an incredibly steep climb. The appreciation of the U.S. dollar against the Western European and Japanese currencies from 1979 until the Plaza Accord in September 1985 was over 50%. It doesn’t take a specialist to figure out that in dealing with that kind of margin, it’s very, very tough for a U.S. businessman or businesswoman to hold on to markets.

At the same time the lesser developed countries’ (LDCs) debt crisis became unbearable. In a matter of months, not years, the traditional surpluses that the United States enjoyed with a number of Third World countries, particularly in this hemisphere, turned into deficits. How does a country like the United States confront such a formidable situation?

The growth of the U.S. economy itself, unfortunately, has had bittersweet results. In 1984 the U.S. economy had a growth rate of 6.8%. We had not registered anything like that since the Korean

5. The Plaza Accord was a September 1985 agreement by the finance ministers of the United States, Japan, West Germany, France, and the United Kingdom to drive down the value of the dollar from its historic highs. The finance ministers also reiterated their commitments to institute domestic economic changes. See N.Y. Times, Sept. 23, 1985, § 1, at 1, col. 6.
War. It does not take great brilliance to figure out that when your trading partners have growth rates of 1 and 1-1/2% and you have a 6.8% growth rate, they are able to sell you a lot more goods than you are able to sell them.

Finally, traditional U.S. agricultural markets have become more and more self-sufficient. Who would have realized just five and ten years ago that both India and the People's Republic of China would be agriculturally self-sufficient today? For those agricultural markets that do exist overseas, we now have to contend with the competition of an even more powerful European Economic Community that is subsidizing its agricultural products in much the same way we have done.

For a moment just think about how truly complex the world has become. Did you realize, for example, that the largest employer in Singapore is General Electric? Did you realize that the largest exporter in Argentina is IBM? The Japanese export market for the United States is larger than that of the United Kingdom, France, West Germany, and Italy combined. Did you know, for example, that the amount of the trade deficit that we sustained last year with Japan—about $60 billion—is just about the same amount of money that the Japanese invested in the United States last year? Or that the amount of investment that the United States made in Japan in the area of plants, equipment, and other machinery is actually greater than similar Japanese investment in the United States last year? I am not passing judgment on any of this. I just want to convey the fact that the world has become extremely complex.

Where does competitive America stand today? There is no question that the next person that we choose as President is going to have a very full plate and a very difficult four years. For example, the trade deficit will continue to hover in the range of $100-150 billion. In the midst of that deficit I believe we will see manufacturers' exports increase and foreign imports remain generally flat. At the same time, however, we will also see oil imports continue to climb, making up in part for increased manufactured exports. Traditional export markets in agriculture will continue to dry up.

In other areas, the LDC debt crisis will place ever-increasing burdens on the United States and the industrialized world, and the problem of allowing those countries to export, and at the same time erect barriers to imports, will be central in the debate. Growth will also be a lingering problem, not so much ours, but that of other leading economic powers. In particular, we need to prod countries
like Japan and Germany to increase their growth rates to allow for
greater U.S. exports. Rising interest and inflation rates must also be
watched carefully.

Finally, on a positive note the United States will continue to wit-
ness the quantum leap in liberalization that is taking place in a
number of countries around the world. Economic fundamentals
dictate a focus over the next several years not only on interest and
inflation rates, but also on capital formation, R&D investment, edu-
cation, work force skills, and retraining.

As we look to the future, let me say what our options are not. They are not a concentration on the ills of U.S. imports, rather than
a central focus on U.S. exports. That's counterproductive. Put
more bluntly, the issue of competitiveness simply cannot be a eu-
phemism for greater U.S. protectionism or for insularity.

In addition, our country cannot be obsessed by unfair trading
practices as though they were a major key to unlocking the competi-
tive genius of the United States. If you were to ask the leading econ-
omists of the United States today how much of the current $156
billion trade deficit would be cut by removing every unfair trading
barrier tomorrow, you would be given a figure between 10-15%.
Yet with all the rhetoric, you would think it was far greater.

Our country cannot adopt Japanese or other foreign models
wholesale as answers to greater competitiveness. These are Ameri-
can problems, and American solutions ultimately must be found.

Finally, let me say that the answers—true answers—to our
problems will not be found in the campaign offices of Iowa and New
Hampshire, but through thoughtful symposiums like this one today.

PROFESSOR KOH: Our next speaker is Richard Levin, Professor of
Economics and Management and Chairman of the Department of Economics
at Yale University, where he received his Ph.D. in economics in 1974. Profes-
sor Levin has authored more than thirty scholarly works on subjects related to
technical change, R&D, economic regulation, and industrial structure. He has
also done research on innovation in the semiconductor industry.

PROFESSOR RICHARD C. LEVIN: Are things really as bad as
they seem? Does a trade deficit in excess of $150 billion signal an
irreversible decline in the competitiveness of American manufactur-
ing? Is our current position in high technology—in semiconduc-
tors, computers, and biomedical products—truly as vulnerable as
our position was a decade or two ago in the smokestack industries?
Will the sun set mere moments after it rises on biotechnology and
superconductivity? Is trade policy the only or even the primary
weapon in our arsenal capable of arresting our decline and buying the time necessary to retrain our factory workers to become waiters and waitresses, sales clerks, and hospital orderlies?

Despite my professional commitment to the dismal science, I believe that the answer to all these questions is "no," although I should perhaps be more cautious and say "not necessarily." Most of the gloom and doom stories we hear about the decline of the American economy are facile, and those who put them forth fail too often to make some crucial distinctions that I would like to highlight in these brief remarks.

First, let me underscore the observation of Professor Hufbauer that the trade deficit and declining competitiveness are distinct problems, but let me pursue the point a bit further. Those who see an across-the-board decline in the competitiveness of American manufacturing as a cause of the trade deficit have got the story almost exactly backwards. The overall trade deficit is not a consequence of the poor performance of U.S. industries; it is a fairly direct consequence of the fiscal policy pursued by the Reagan Administration. We have seen drastic reductions in personal income taxes. To the disappointment of supply-siders, but not to the surprise of most professional economists, these cuts have not produced the increases in private savings and domestic investment that were wistfully expected by the Administration. In consequence, enormous federal deficits have persisted, and this debt has been financed in large measure not by increases in private domestic savings, but by a massive and continuing influx of foreign funds holding up the value of the dollar, and making our exports uncompetitive in world markets. The broad pattern persists despite the recent decline of the dollar, and it is likely to persist until we cease, by conscious policy measures or by the bitter pill of recession, to finance our current consumption by borrowing from abroad (and by selling our capital stock to foreigners).

Our trade deficit, therefore, is not primarily a consequence of the overall performance of our manufacturing sector. Myopic fiscal policy is the underlying cause of both our trade deficit and the widespread inability of our manufacturers to compete effectively. If we can reduce our borrowing from abroad, the overall trade deficit will shrink, and many, though not all, of our manufacturing industries will move from deficit to surplus on current account.

If our illness is not to become metastatic, it is necessary to make a clear distinction between the problems of the sunrise and the sunset
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industries. Some of our more mature manufacturing industries—textiles, apparel, footwear, and steel, for example—are in the midst of long-run decline. The decline of these industries is by no means an exclusively American problem; the Europeans and the Japanese have had a comparable experience. The sunset industries are migrating from the older industrial economies to lower-wage economies, and protectionist measures in Japan and in the United States have proven incapable of arresting their decline. Indeed, the rents generated by protection rarely have led to reinvestment and revitalization of the afflicted domestic industry. Often, the rents are captured by organized labor in the form of higher wages, rendering the industry even less capable of competing internationally.

The proper approach to the sunset industries is to facilitate adjustment of the labor force through retraining and re-employment. On these matters, I am in broad agreement with Professor Hufbauer. In particular, it is important that adjustment assistance be used for purposes of retraining and re-employment, not for extended unemployment benefits. In this respect, the Japanese have a policy innovation we should consider quite seriously. In Japan, firms play a much larger role, and government agencies a much smaller one, in relocating workers. Multiproduct firms get special subsidies for moving the employees of a designated depressed industry to jobs in affiliated operations in other industries. We should also consider the closely related idea of subsidizing firms for acting as employment agents for their displaced workers.

Finally, we come to the sunrise industries, which happens to be my particular area of expertise. The picture here is really quite different; setting aside the highly publicized complaints of the merchant semiconductor industry, a close look at the data reveals that our high-technology industries have held up rather well.

There has been a substantial increase in the penetration of high technology imports, but, with the exception of Japan, all our major trading partners have a share of such imports in domestic consumption that is at least double our own. Our share of total worldwide OECD (Organization for Economic Cooperation and Development) high-technology exports has slipped from a bit more than one-third to a bit less than one-third. Japan’s dramatic gains have come primarily at the expense of other OECD countries.

A particularly useful indicator of the comparative advantage of our high-technology sector is the U.S. share of all OECD high-technology exports divided by the U.S. share of all OECD manufactured
exports. By this measure, the performance of U.S. high-technology industries has remained roughly constant since the early 1960s—at a level substantially higher than that of all but one of the other large OECD countries. Only Japan has risen to rough parity with the United States in the degree to which its exports are tilted in favor of high-technology industries, and once again its gains have come at the expense of Europe and Canada, not the United States.

More purely technological indicators of our international position give even less cause for pessimism. Much has been made of the enormous increase in the share of U.S. patents granted to foreigners, but the increased filing of patent applications outside the country of invention has been a worldwide tendency. Consider the following measure: the ratio of a country's external patent applications to the applications it receives from foreigners. We might think of this as a crude balance of trade in patent applications. By this measure, the United States “exports” nearly three times the number of patent applications it “imports.” No other country comes close; Japan and West Germany have ratios of exports to imports that are just below two. Switzerland just about breaks even, and all remaining OECD countries are net importers.

I report all this not to suggest that we should be entirely passive about our high-technology industries. The Japanese have made substantial gains, and we will not retain our leadership in high-technology without continuing to support and strengthen our basic research enterprise. Indeed, we must also take steps to improve the performance of our system of primary and secondary education, where our comparative performance has slipped drastically. We have had great success with broad government support for basic research, but very little success with direct attempts to intervene in the development of applied technology. We should keep this in mind as we enter the era of superconductivity. Finally, the spur of competition—usually buttressed by a system of intellectual property rights—has created far more powerful incentives to develop new technology than has the shield of protection. We should strongly resist trade protection, antitrust exemptions, and other proposals to insulate our high-technology industries from market forces.

Let me summarize in a way that oversimplifies. First, our overall problem of competitiveness is a problem created by macroeconomic policy. It is best solved by macroeconomic policy. Second, trade policy has not stopped, and probably will not stop, the sun from setting on our declining industries. Policies that facilitate the exit of
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labor and capital from these industries and direct these resources elsewhere are more likely to be productive than trade intervention. Finally, if we want the sun to shine on our high-technology industries, support for our educational and research infrastructure and enforcement of our intellectual property and antitrust laws will provide a more enduring solution than the temporary palliatives of countervailing duties and other forms of trade protection.
PROFESSOR HUFBAUER: I'd like to use my parting shot just to respond to a point Senator Chafee made on the budget deficit. Like the majority of economists, I place great emphasis on the budget deficit. You deal with it either on the expenditure side or on the tax side. Now if I were czar, I would cut all those entitlements. I'm not the czar and I don't think anybody can cut all those entitlements. I'm turning to what I think is the practical result, which is that you have to start thinking about tax increases or user-fee increases. I much prefer talking about a value-added tax for deep structural reasons rather than more corporate income tax or going back on the personal income tax. That's where I think the debate is.

Having said that, let me just back up from the budget deficit. The trade deficit-budget deficit is not a one-for-one relationship. I know that economists widely oversell as a way of selling it all. And they have more or less sold this one-dollar-on-the-budget-deficit-equals-one-dollar-on-the-trade-deficit theory. The econometric research done by the International Monetary Fund, done by the Defense Research Institute, done by everyone, however, shows the generous relationship is one-for-three. You cut the budget deficit three dollars, you cut the trade deficit, or more precisely the current account deficit, one dollar. That's quite a bit. The budget deficit is the single biggest cause, but it's certainly not a one-for-one result. That's why I speak about the necessity of more exchange rate devaluation, and, God forbid, recession as part components of the overall adjustment story. Finally, I think it is inevitably going to be forced by the financial system if not by responsible fiscal management that we will go to a merchandise trade balance, if not a trade surplus, in the 1990s. It is conceivable we'll get to a $50 billion surplus or even higher. I think the financial markets will force that upon us.

I think the competitive problem will still remain. It will remain in the form of lower productivity growth than in Japan and some other countries and continued comparative success by some of these competitors in the high-tech area.

AUDIENCE MEMBER: I have a question for Senator Chafee. Some have suggested that we model what is happening as a strategic game of "chicken" between the President and Congress, that is, the policies that everyone is articulating are mutually exclusive given the deficit that we have. At some point somebody has got to veer the car off to the right to avoid disaster. And I'm just wondering,
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from the perspective of the Senate, who do you think is going to say "chicken" in the end? Given the deficits that we have, eventually we have to pay for those deficits either by running future surpluses or, I guess, by monetizing the deficits and risking hyper-inflation. In the last analysis, who do you think is going to give?

SENATOR CHAFEE: I agree with you and I think we'll get a pretty good indication of whether there is going to be some amicable resolution of this when you see what the President does on the extension of Gramm-Rudman-Hollings. If he signs it, I think there's a real harbinger of success in cooperation between the Congress and the President in trying to resolve these problems because if nothing is done, an area that he particularly cares about, defense, will take a hard cut and he doesn't want that. So if we can cooperate, I think we can find a solution to this dilemma. It's not going to bring the deficit down to zero, but it's going to keep it on the downward path. And even keeping it on the downward path is quite an achievement because, as you know, we were the beneficiary of a windfall due to the Tax Act and a host of people coming in and taking advantage of the lower capital gains rates in this current fiscal year. So that's a very important decision.

AUDIENCE MEMBER: I'd like the panel to discuss what I see as almost a systemic problem in American business and politics, and that is, we wait for a problem really to hit us in the face before we start to take measures to address it. The way to avoid these situations is to do things prior to the problem actually manifesting itself. The Senator spoke of the problem of education as did all of the panelists, and yet we see inconsistent signals; for example, the tax bill last year took away the interest deduction on student loans. That's not my primary concern, but the problem, I think, is a real one and maybe it's a political issue more than an economic one. But I think if you look at other nations, they tend to think more long term while we focus on the short term. I'd like to get your viewpoints on that.

SENATOR CHAFEE: Obviously it would be better if we thought in the long term, but frequently, neither the country's will nor its support is there for it. I'll give you a perfect example: the Social Security fix we made in 1983. Social Security was clearly in danger. The whole system was underfunded, and as a result, finally a commission was formed and the action was taken but the action could well have been taken earlier. It wasn't taken earlier because of the lack of political will and support in the country. As far as education
goes, I think these warnings have been coming out, such as the Carnegie Report. I'm not sure I agree with you that the tax bill was a setback for education, and there may be dispute over that. Interest was not deductible for student loans, but the overall rates were so much lower.

**DEPUTY ASSISTANT SECRETARY MOORE:** Let me add to what Senator Chafee just mentioned. I don't think that procrastination in the face of serious problems is peculiar to the United States. But in fact, my remarks were aimed in part at accentuating the fact that 40 years in the trading world has certainly made a difference, and we have seen warning signs not only in education, but also in terms of our competitiveness for many years. One of the most difficult things I must tell you, from the perspective of the Department of Commerce, is to convince small- and medium-sized businesses in this country that it is to their advantage to seriously consider exporting overseas, particularly those companies that have the financial wherewithal and the innate ability to actually export. We can see down the road where there is going to be a greater need to do this, but the question always is the ultimate product. This Administration walked into office and inherited an LDC debt crisis, an incredible budget deficit, and a trade deficit. One can still argue about what has happened during the Reagan Administration. But the fact remains that we have gone through a bit of a house cleaning these past several years. Maybe we have not shrunk substantially the growth rate of the budget deficit or the trade deficit, but there is now a serious effort to apply ourselves that has not existed for some time. I think we will always face this kind of problem, the tugs and the pulls that exist between the Congress and the President. When we deal with this kind of issue, I am reminded of that wonderful quote of Winston Churchill's that democracy indeed is the worst form of government, with the exception of all the rest.

**AUDIENCE MEMBER:** I was interested in Professor Levin's view that our high-tech exports had done okay. I want to ask you about that because there was a study done last fall before the data was in that predicted that for 1986, for the first time in history, we would have a deficit in high-tech trade. In fact the numbers came in and we had a deficit in high-tech trade in 1986 for the first time in history. I'm wondering if the issue is really whether our exports in high-tech trade have held up or whether the problem is that because high-tech is about the only area where we still have a comparative advantage over the rest of the world, our high-tech has to lead the
rest of our economy in order to make up for the fact that we don't have a comparative advantage anymore in low-tech? Is it possible we don't have a problem and all we are doing is holding our own, holding steady?

PROFESSOR LEVIN: What I'm trying to say is not that high-tech is performing in the absolute sense of having a positive trade balance. The point is that the overall negative trade balance is depressed by the macroeconomic factors that I indicated. We are importing goods and paying for them by selling off ownership of our economy and by borrowing. And the point I was trying to emphasize is that the high-tech industries are performing better than the others, and if we are near break even in high-tech that means we are negative $150 million on all the rest. When we get into a position through macroeconomic measures that will bring us closer to an overall budgetary foreign trade balance, we'll have a considerable surplus in the high-technology industries. That's the point. When the dollar shifts, our trade balance should move in all commodities in our favor, and when that happens, high-tech should have a considerable export surplus. The other point I was making is that yes, the Japanese are catching up, but their gains have come far more at the expense of Europe than at the expense of the U.S.

AUDIENCE MEMBER: My question is for Assistant Secretary Moore, although I imagine Professor Levin must have some speculations on it also. As a delegate to the Uruguay Round, I wonder if you could tell us about an important—but untouched—subject for today's discussion, and that is the international trade in services. Is it still appropriate to say that we should be importing Japanese cars and exporting lawyers? Is there a trade deficit in the service area?

DEPUTY ASSISTANT SECRETARY MOORE: Not being a lawyer, I would be delighted to export lawyers. Today services make up 67% of the gross national product of the United States. That's staggering. But regrettably the concern has been raised in some quarters that this has been totally to the detriment of the manufacturing sector of this country. Notwithstanding certain business trends up and down, the fact remains that the manufacturing sector in this country has remained rather flat in that it has not declined in terms of actual jobs. Services are going to play an extremely important part in the future of U.S. trade. We are trying, not only with services, but with the issue of investment and intellectual property rights, to see that the general agreement on tariffs and trade in Geneva will now encompass an area that it has not covered. We have
fortunately had an ally in Japan in taking on such a subject as services. I will be going to Geneva in the next month to take up the issue of services, and indeed, it is our hope that we will come up with a regimen that will be established much in the same way as our goods were. How it will ultimately end up, because we have an awful lot of opposition from countries like Brazil and India in this new round of talks, God only knows, but so far so good.

AUDIENCE MEMBER: I am a first-year student at the School of Organization and Management. Before I came here I spent three years in tax analysis in the Congressional Budget Office. Gary Hufbauer has made the argument that there is something in the neighborhood of $5-10 billion of economic rent which is transferred to foreign countries with quotas. He has argued, as most economists would, that tariffs are more efficient than quotas. Consumers here are paying for these quotas with higher prices. Why not "tariff-ify" the quotas? I am curious to know what the panelists think about the idea of the "tarification" of quotas if you are going to have them. Why not "tariff-ify" or auction quotas as suggested earlier?

PROFESSOR LEVIN: The answer to the first question is that it is outside the current international framework of the GATT to do a lot of raising of tariffs. It means a major change in the whole international trading regime to start imposing lots of new tariffs. Auctioning quotas has a number of desirable economic effects because you get the same benefits as you would get from a tariff in the sense that the government captures the revenue that would be raised by a tariff and can use it for the retraining programs and redistributional purposes that are of the type Gary Hufbauer was advocating. So that's really the question, not, "Why don't we have tariffs?" But, "Why don't we auction quota rights?"

DEPUTY ASSISTANT SECRETARY MOORE: We hit a round of trade negotiations in the Tokyo Round that tried to put an end to an awful lot of tariffs. It was a much easier round than what we are experiencing right now because obviously tariffs are much more quantifiable. Now we're dealing with non-tariff barriers and we're also, to a certain extent, dealing with the entire quota issue. I'm not going to sit up here and try to weigh quotas versus tariffs. I am simply going to say that the notion of auctioning off quotas is something that certainly has been discussed at various times and it has not been put to the test yet. It would be a fascinating way, purely from a theoretical academic standpoint, but a lot of us hate both.
AUDIENCE MEMBER: I am a graduate of Yale Law School and an attorney at Akin, Gump, Strauss, Hauer & Field. With respect to planning ahead and coordinating trade and economic policy, do you all feel that there is a role, or have you thought about a role, for restructuring trade policy infrastructure, perhaps under a new Department of Trade?

SENATOR CHAFEE: There has been deep consideration of whether there should be a Department of Trade as well as the U.S. Trade Representative. It has been resisted by the Department of Commerce vigorously, and we've really rejected the idea. Having thought about it, we feel that the USTR now is on the cabinet level. He has access to the President and we don't see virtues in changing to some kind of a Japan-style setup. The Department of Commerce did want a Department of Trade, but they wanted it to be the Department of Commerce, just change the name, and that was resisted by the USTR, and we agreed with that in the Finance Committee.

DEPUTY ASSISTANT SECRETARY MOORE: For equal time, the Department of Commerce would gladly have been absorbed by USTR. We were prepared to take that up. Recognize, however, that USTR has about 100 individuals. The Department of Commerce currently has about 33,000. It was kind of like the canary swallowing the elephant, but a former graduate of this school, Malcolm Baldridge, was in the forefront of trying to make some kind of sense in regard to the policy framework that we have in Washington. I will never forget being in Dallas for the last meeting of the President's Commission on Industrial Competitiveness. The former Secretary of Commerce and U.S. Trade Representative, Frederick Dent, was watching, as I was, this incredible graph of what an outside consultant had perceived to be the various reporting relationships that existed within the executive branch of government in the area of trade, not even discussing the legislative branch. At that moment Mr. Dent jumped up and said, "Oh my God, it looks like spaghetti!" Indeed, I began to refer to it as the "spaghetti factor" in Washington. I think it certainly can be argued very seriously that we have a somewhat untenable situation. If I were to write an open letter to the next trade team that comes into office after the election in 1988, at the top of my request list would be a more manageable system that not only we in the government could understand but the people outside as well.

PROFESSOR LEVIN: From an economist's perspective on that administrative reform issue, the more tangled that spaghetti, the
lower the likelihood that there will be protective measures, so I
would favor retention of the existing system.

MR. APPLEBAUM: One of the USTR representatives, Judy
Bello, earlier today made clear what most of us in Washington
know, that is, if a trade bill does pass—and there are lots of politics
involved with the election and otherwise—it will pass because the
Administration very much wants the authority to negotiate the Urug-
way Round, which has been mentioned here several times. What I
would like to know is whether the Uruguay Round matters to the
competitiveness of U.S. industry? Is the competitiveness of United
States industry dependent on the continuation of international mul-
tilateral negotiations, or is that merely for politics and philosophy
rather than practical results?

SENATOR CHAFEE: I'll just start off and say I think it's essential
to U.S. competitiveness because, absent the success of those rounds,
I think that the world as a whole will drift toward greater protection-
ism. When there is an erection of tariffs, the competitive edge is
taken off. The need to compete is lessened to a great degree, and I
think it would be a disaster if those rounds did not succeed and, of
course, the Canadian negotiations we're all deeply worried about.

PROFESSOR LEVIN: It would be small comfort to come out a
little bit better off than the other guy in the kind of negative-sum
game that trade warfare represents. A failure to pursue continuing
liberalization of trade is going to have multilateral impoverishing
effects as the history of this kind of protective measure shows. Even
if protectionism were to our relative competitive advantage, it is not
going to be to the benefit of our ultimate prosperity.

DEPUTY ASSISTANT SECRETARY MOORE: There are those
who say, and I would agree with them, that notwithstanding arms
control deliberations, the launching of the Uruguay Round in Punta
del Este was the single most important conference that has been
held in decades. There is a large number of people in the area of
trade who have been watching from a front row seat who have come
to the conclusion that we will be at a precipice of chaos if something
is not done to allow for a greater sense of the traverse of world com-
merce. We have in Geneva a dispute settlement system that is un-
fortunately extremely antiquated. We've dealt with some serious
issues pertaining to things like canned fruit and pasta, issues that
literally have taken 14, 15, and 16 years ultimately to resolve. If we
do not put into effect a dispute settlement system that allows for
some kind of rules and regulations in international commerce, there is no question that ultimately U.S. competitiveness will suffer.

MR. APPLEBAUM: Is a dispute settlement system so important that it is worth accepting a trade bill amending the trade laws in an "arguably protectionist" way?

DEPUTY ASSISTANT SECRETARY MOORE: Ultimately we are going to have to see what happens with the trade bill, and I would not want to answer that based on what we have right now. But the fact remains that if we don't go the way of multilateralism, we've got to go the way of some kind of bilateralism. That's why I've been a great proponent of these U.S.-Canadian free trade talks to send a message to the 95 nations currently belonging to the General Agreement on Tariffs and Trade that if they are not willing to come to grips with some kind of international regime, then the United States and Canada and other countries will go it alone. Ultimately, that kind of relationship between nations has got to occur, and if it weren't for the Uruguay Round, and the prospect of some successful conclusion, I think that the trade bill would be rife with even greater protectionism than it currently is.

MR. STEIN: I certainly agree with the panel that the trade deficit and the budget deficit are important in determining competitiveness or noncompetitiveness. But, to a fairly substantial extent, industries that have been targeted by this panel as current losers are losers because the terms of comparative advantage have been changed by foreign government targeting policies, for example, in the semiconductor commodity chip industry. We can see now that foreign industrial targeting policy is aimed directly at supply transport aircraft. To what extent does the panel think that policy initiatives to combat industrial targeting are in the national interest and, if they are, what sort of policies would you recommend?

SENATOR CHAFEE: In the Senate version of the new trade bill, there is a specific prohibition, a reaction to deal with targeting. I would disagree with you on your first statement that the industries that we have been talking about have suffered from targeting. We were talking, at least I was, about steel, footwear, and textiles, and I don't think the decline of those industries has resulted from targeting.

MR. STEIN: I disagree with respect to steel. The other two I'll give you.

SENATOR CHAFEE: In any event, targeting is listed as a specific violation in the Senate version of the trade bill.
PROFESSOR LOWENFELD: I understand why the trade deficit produces foreign balances which help to finance our budget deficit, but I've never understood why it is that people think the budget deficit produces the trade deficit. This seems to be a cliché and a given. I'd like somebody to explain it.

PROFESSOR LEVIN: The government has got to borrow and someone has to hold the debt. Either we've got to come up with it abroad or domestically. Either people in the United States or people outside the country are going to hold government debt. What's happened in the last decade is that people outside have increasingly been holding government debt. Hence, it bids up the value of the dollar, raises the U.S. price level relative to foreign prices, and that creates a trade deficit. That is the causal chain; I think that is probably the consensus view.

PROFESSOR LOWENFELD: If that is the cause of the rise of the dollar, then if the dollar goes down, it ought to be reversed.

PROFESSOR LEVIN: What's the controllable instrument? Presumably it's all interrelated. It's all one big set of simultaneous relationships. But where do you have a lever to move that system? One lever is government tax and expenditure policy. The government deficit is a controllable policy instrument, and to a certain extent it's true that if you could shrink it you would set off this chain of causation that would in turn devalue the dollar and improve the trade deficit.

PROFESSOR LOWENFELD: Isn't it true that both Japan and Germany have had budget deficits?

PROFESSOR LEVIN: They are not of the massive proportions of ours and, again, we are always oversimplifying. We think of the U.S. and the rest of the world and, in fact, it's a complicated picture. The dollar has not devalued as much with respect to some of the European currencies as it has with respect to the yen.

DEPUTY ASSISTANT SECRETARY MOORE: I'll give you a couple of projections in regard to the depreciation of the U.S. dollar. You will find if you look at the figures by the end of this year that, notwithstanding Germany, the United States will enjoy by year's end a surplus with the European Economic Community. If you look over the figures, particularly from Europe and elsewhere, you will find that our manufacturing exports will, in fact, be increasing rather substantially by the end of the year. We certainly have seen a rise in volume terms. We've had a serious problem in terms of seeing that a J-curve, a perfect J-curve, would ultimately work out
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for us. It's worked out much better in Europe than it has, for example, in Asia. But I will tell you one of the interesting phenomenon that we have found and that is perhaps it's a cultural thing in regards to Japan. The J-curve has not worked out terribly well with Japan. The Japanese and their exporting overseas have, in fact, allowed for reduced margins of profit to be able to hold onto market share, and we have seen that much more with Japan than we have with the Europeans. A good example is the semiconductor industry. There were a number of things the Japanese did in semiconductors. But some of them, like fostering collaborative research, probably had a lot less payoff than is commonly supposed. The thing that really mattered was the closure of the Japanese market to access by American firms, protecting that domestic market. That is a restrictive trade measure and the role of trade policy is, as we have been saying, to try to get rid of those. Now the response is not to erect our own restrictive trade measures, or maybe to use that only as a strategic chip once in a while! But the idea is to try and get that access opened up.

MR. STEIN: The United States has tried since 1975, and again in the negotiations over the 1986 agreement, to do exactly that without success. I wonder if there comes a time when you are prepared to deny access to the United States market in order to achieve that sort of result.

PROFESSOR KOH: I have a question about the institutions and ideology point I raised before to Professor Levin. Even if Ronald Reagan were to announce that he was a Keynesian and start these fiscal policies going, we still have the problem of whether the other countries with whom we are running trade deficits would also stimulate their economies. If I read the Plaza Accord, the Louvre Accord, and the Reagan-Nakasone summit correctly, there is agreement to coordinate monetary policy but only lip service to fiscal policies. Institutionally speaking, is it really possible for us to get them, these other nations, especially Japan and West Germany, to do anything after the semiconductor deal? It is not clear to me that the Japanese are really stimulating their economy all that much. Even if your dream came true, and Reagan were to engage in serious fiscal policy, would that solve the problem?

6. The Louvre Accord was an informal agreement in February, 1987, by the finance ministers of six major industrial democracies to stabilize the value of the dollar following its fall since the 1985 Plaza Accord. See N.Y. Times, Feb. 23, 1987, § 1, at 1, col. 1.
PROFESSOR LEVIN: Well, you raise a good point. Any fiscal measures we take have inevitable leakages abroad so that we don’t necessarily get as much “bang for our buck” as we would hope. That is part of what Gary Hufbauer was talking about when speaking of the less than wonderful effect of improving the budget deficit, on the trade deficit. International coordination is desirable. It is a serious structural matter in the world economy that our interdependence is not fully institutionalized, and we don’t have the institutional machinery to deal with it. That doesn’t mean we shouldn’t do something about our own deficit. It means that the effect of doing that can be in part offset by foreign governments.

PROFESSOR KOH: I see that our time is up. In conclusion, I would like to thank our panelists, the audience, and the Yale Law & Policy Review for contributing to a successful symposium investigating “American Trade Policy: Actors, Issues, Options.”