S. HRG. 100-6, Pt. 3

MASTERING THE WORLD ECONOMY

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

FEBRUARY 3 AND 5, 1987

(Part 3 of 4)

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

71-855 WASHINGTON : 1987

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

COMMITTEE ON FINANCE

CONTENTS

PUBLIC WITNESSES

ADDITIONAL INFORMATION

MASTERING THE WORLD ECONOMY

TUESDAY, FEBRUARY 3, 1987

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m. in Room SD-215, Dirksen Senate Office Building, the Honorable Lloyd Bentsen (chairman) presiding.

Present: Senators Bentsen, Baucus, Bradley, Riegle, Rockefeller, Daschle, Danforth, Chafee, Heinz, Wallop, and Durenberger.

[The press release announcing the hearing and prepared written statements of Senators Rockefeller and Heinz follow:]

[Press Release #H-12]

FINANCE COMMITTEE CHAIRMAN BENTSEN ANNOUNCES FURTHER HEARINGS IN THE SERIES "MASTERING THE WORLD ECONOMY"

Washington, D.C.—Senator Lloyd Bentsen (D., Texas), Chairman, announced today further hearings on "Mastering the World economy," a series of trade oversight hearings in the Senate Committee on Finance.

The hearings will be held on Tuesday, February 3, 1987, and Thursday, February 5, 1987, and will begin each day at 9:30 a.m. in Room SD-215 of the Dirksen Senate Office Building.

The witnesses at these hearings will be as follows:

February 3, 1987—Mr. James D. Robinson, III, Chairman and Chief Executive Officer, American Express; and Chairman, Business Roundtable Task Force on International Trade and Investment; New York, New York.

Mr. Mark Shepherd, Jr., Chairman, Texas Instruments Incorporated; Dallas, Texas.

February 5, 1987—Mr. Colby H. Chandler, Chairman of the Board and Chief Executive Officer, Eastman Kodak, Inc.; and Chairman, President's Export Council; Rochester, New York.

Mr. Robert W. Galvin, Chairman of the Board, Motorola, Inc.; Schaumburg, Illinois.

Mr. William Lilley, III, President, American Business Conference; Bronxville, New York.

The witnesses for these hearings have all been invited by the Chairman. Oral statements by uninvited witnesses will not be accepted.

STATEMENT OF SENATOR JOHN D. ROCKEFELLER IV, FEB. 3, 1987

I would like to thank you both for your excellent presentations today. I would particularly like to commend the Business Roundtable for its recommendations on trade policy and actions that this country should take in the coming months. It is a comprehensive package of trade recommendations and includes the critical message that these actions must be taken in coordination with budget, fiscal, and monetary policy. This cannot be stressed too much.

We have often been told in the past that if we were successful with all our market opening efforts, the bilateral trade deficit with Japan would only improve by 10 to 15 billion dollars and that our global trade deficit would improve by a mere 25 to 30 billion dollars. Those making this claim then argue that because this represents barely one-sixth of the total trade deficit, it is almost not worth focussing on market opening.

I find this type of argument sophistry of the worst kind. Using what has become the standard measure of 25,000 American jobs for every billion dollars of exports, complete market opening with Japan could represent 375,000 jobs and world-wide market opening could lead to three-quarters of a million new jobs. What a boon this would be to our economy in macroeconomic terms as well as on the human level by putting so many people back to work!

I reject totally the argument that market opening efforts are unimportant because they relate only to a small part of the problem. The process of dealing with our trade crisis is multifaceted, and each stage is critical. A closed market provides foreign industries with incalculable benefits, although the consumers in those countries may suffer dramatically.

Domestic expansion in Japan will not help our trade deficit unless the Japanese market is far more open than it is now. Stronger currencies in Korea and Taiwan will not help our exporting industries unless the currency change is accompanied by dramatic market opening measures in those countries. American goods and services, no matter how competitively priced and no matter how high their quality, will not sell if they cannot even get in the door.

Market opening measures are not the end-all and be-all for our trade problem. They are, however, a necessary, although not sufficient, element in the overall package. Our efforts in this area are key, and we must encourage our trading partners to move in this responsible direction. The viability of the international trading system that has served us so well heretofore is at stake. I hope we can provide our trade negotiators with the necessary tools to allow them to get these markets open while we work domestically on enhancing our competitiveness.

STATEMENT BY SENATOR JOHN HEINZ, COMMITTEE ON FINANCE, HEARING ON TRADE POLICY, FEBRUARY 3, 1987

Mr. Chairman, I have only two brief observations to make. Last year's trade deficit was $170 billion; and we long ago ran out of excuses for it. It is not just the dollar. It is not the federal budget deficit. It is not lack of competitive effort by Americans trying to export.

Sooner or later the government is going to have to wake up and notice the resurgence of mercantilism that is transforming the world trading syste. This is a war in every since of the word, and we are clearly losing. Senator Bentsen understands that. So do most members of this Committee, and, indeed, most members of Congress.

It is time to translate that understanding into specific action. The Chairman's bill will appear shortly. Several members of the Committee, including myself, have introduced bills as well on a variety of specific trade issues. Jim Robinson, wearing his Business Roundtable hat, has also done an extraordinary job of building a business consensus in this complex area. I have seen his recommendations, and I hope he will mention them today. While they are not nearly as far reaching as I would like, they represent a major step forward from last year and are a clear sign the business community is prepared to work with the Congress on developing trade legislation. My concern is that business consensus may evaporate if companies forms only on *their* short term problems and oppose solutions to problems in other sectors. The trade problem is not simply a steel problem, or even a manufacturing problem. It also involves agriculture, services, and many other specific sectors. A responsible bill will address all of them, not just the handful that lobby the hardest. I hope today's witnesses will reflect that breadth of concern I know their colleagues in the business community share. That will greatly facilitate the process of putting together a bill.

The CHAIRMAN. The hearing will come to order.

I would say for the benefit of those in the audience that these hearings start on time. Some of the members have not become accustomed to that yet, but they will. We also have some competition with other committees this morning. I am sure that as we progress we will get a full complement of members who will appear at one time or another as we go ahead. But the competition of other hearings is a part of the problem.

This morning we will have only two witnesses, because we want to give them a full chance of developing their points of views, and then for those members who will be appearing, to have a full opportunity to question them at some length. There has been a tendency in a lot of hearings to have six or eight witnesses, and they are allowed one minute each, and they really can't develop their point of view with those kind of limitations.

I think we are particularly fortunate this morning to have two very distinguished businessmen who have had extensive experience in international trade. Considering the limitations on their time, I think it is evidence of their deep interest in the subject that they have cleared their dockets, or their engagement books, to be here this morning.

We have Mr. James D. Robinson, who is the chairman and chief executive officer of American Express; the chairman of the Business Roundtable Task Force on International Trade and Investment, residing in New York. And Mr. Mark Shepherd, Jr., the chairman of Texas Instruments, from another great metropolitan area, Dallas, Texas.

So I would like to have as our first speaker this morning, Mr. Robinson. If you would proceed.

STATEMENT OF MR. JAMES D. ROBINSON III, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, AMERICAN EXPRESS; AND CHAIRMAN, BUSINESS ROUNDTABLE TASK FORCE ON INTERNATIONAL TRADE AND INVESTMENT, NEW YORK, NY

Mr. ROBINSON. Thank you very much, Mr. Chairman. I am pleased to be here at these landmark hearings, particularly, since you are asking a number of broad scale and fundamental questions, questions like what type of world economy should we be striving for, and how can the United States earn its way in it?

These questions are similar to the ones that Congress asked itself just after World War II. Our answer then was the establishment of a multilateral system. We created the IMF and the World Bank. At that time we proposed the creation of the International Trade Organizations, or ITO, as it was called.

The ITO was intended to be a full fledged international organization, setting out detailed rules—mechanisms, including dispute settlement procedures—to govern international trade. It addressed not only goods but also services and investment. Unfortunately, the ITO was killed by apathy of the business community and Congressional opposition. We were left with only a truncated version which subsequently became the GATT.

Since that time, obviously, a great deal has changed.

Europe has become a formidable economic rival and Japan has emerged as the world's second largest economic power. Korea, Taiwan, Singapore, Brazil and others are becoming industrial powers in their own right.

So the challenge is very clean, and that is: How can the United States maintain and improve its standard of living and remain competitive when it is no longer the dominant world producer of many goods and services?

Our Nation is facing a set of complex and very interrelated problems that significantly affect our competitive position around the world. And certainly you are very familiar with those problems: the enormous domestic budget deficit, the fact that the United States is now a debtor nation with a foreign debt estimated to reach a trillion dollars by the early 1990's, inadequate productivity, the strong dollar, the third world debt crisis, trade barriers. You know, these are tremendous problems, tremendous problems. But I do believe there are some things that we can do about them. Let me list five.

We need to fix GATT, make it more like the ITO that was proposed after World War II. Second, we need to negotiate a free trade agreement with Canada this year. Third, we need to focus more on our bilateral relationships, especially with Japan. We need trade legislation; we need it this year. And, last, we need to be tougher at the negotiating table.

What do I think our objectives should be? The first—and we should not lose sight of this—is to preserve and promote an open trading system, because like it or not, the growth of the U.S. economy depends importantly on expanding the total world pie so that we can compete for a bigger piece of a bigger pie. And as long as the pie can be enlarged, trade need not be a zero sum game.

Second, we must conform GATT to today's trade and investment environment and reality. Give it the rules, the mechanisms, the staff, and the status that will allow it to work.

Third, we have to defend our own interests if others do not play by the rules. We have got to toughen up our posture at the negotiating table. And I believe the USTR is doing just that.

Fourth, we need to change with the times. The United States has always thrived on its ability to embrace new ideas, to develop the new technologies, to be entrepreneurial. We cannot perpetuate buggy-whip industries. We need realistic measures to help individuals and industries adjust.

Now how do we achieve these objectives? We achieve them in the GATT negotiations, in bilateral trade agreements, and, where necessary, on our own.

First, the GATT. I was a U.S. delegate to the Ministerial meeting in Punta del Este last September. The launching of the new trade round was a major step forward. The United States has considerable leverage and support going into these negotiations, and I believe we can reach agreements that will be beneficial to all trading nations, including the United States.

Now, of course, the trade round cannot and should not be a substitute for an aggressive trade policy. But if the total pie is to grow, we must have a multilateral framework, even if it is imperfect. In my view, a world without GATT would be worse than New York City without traffic lights.

The major key to the success of the GATT talks is strong and continued support from Congress and the private sector. The Business Roundtable supports the new round and a comprehensive agenda. It is time for the Administration to work closely with Congress and the private sector on this effort.

It is also time for Congress to go on record in support of the trade talks. The U.S. Trade Representative must be given clear objectives and flexible negotiating authority.

Now what about bilateral negotiations? Here, the immediate concern is the United States-Canada free trade talks.

The United States and Canada, as you know very well, have the largest bilateral trade in the world, $113 billion in 1986, with the U.S. merchandise deficit at $24 billion. These negotiations are crucial. A comprehensive agreement with the Canadians would create a powerful market-oriented free trade zone. We have to face the possibility that the European Community may one day tighten its ranks against the rest of the world and that the GATT negotiations may not succeed. And in such a world, the Canadian market would be even more important to the United States.

If we are successful in Canada, we can use those talks as a model for multilateral agreements in the GATT. And if we fail in Canada, which is our largest trading partner and neighbor, how can we hope to be successsful at the GATT table?

I am disturbed that the free trade talks have met with a big yawn in this country, particularly with the press. This is wrong, because we have an incredible opportunity at the present time.

This Canadian effort deserves great attention and high priority in the Administration and Congress. And I commend you, Mr. Chairman, for taking the time to make your trip to Ottawa.

This brings me to another bilateral relationship: Japan. In 1986, Japan ran an estimated $60 billion trade surplus with the United States. Obviously, these numbers are of serious concern. They will probably get bigger before they turn around. In my own view, Japan is making a number of positive changes. Certainly a great deal remains to be done, however.

Since 1985, the yen has appreciated 40 percent against the dollar. Japan has taken steps to open a number of its markets, including its financial markets. Prime Minister Nakasone has endorsed a far reaching plan for making the Japanese economy less export oriented over the longer term.

In addition to this, I believe Japan has the unique responsibility to use its financial surplus to play a positive role in the global economy. Just as the United States carries the major burden for the military security of the world, Japan and other chronic trade surplus countries should shoulder major roles in supporting the world's economic security.

George Marshall said 40 years ago, "Without normal economic health in the world, there can be no political stability and no assured peace."

The Administration, Congress and the U.S. Trade Representative should continue to encourage Japan and other surplus countries, like Germany, to open their markets to exports, especially from the LDCs, and to stimulate their domestic economy. But an equally important contribution would be to use their excess savings and surplus to encourage structural reform in the LDCs that could open developing country markets to the benefit of all trading nations.

Again, the bigger the pie, the better for everybody.

Finally, I would like to comment on what we can do now on our own to attain our objectives in the trade area.

In summary, the Business Roundtable recommends that Congress pass legislation, (1) to authorize the new trade round with fast track legislative procedures; (2) transfer authority to take action under Section 301 from the President to the USTR and strengthen 301 to provide greater certainty in resolving cases;

(3) Provide greater protection for intellectual property by eliminating the injury requirement and the domestic industry test from Section 337 cases.

(4) Amend Section 201 of the Trade Act to place more emphasis on adjustment, broaden the scope of adjustment, ease the standards for obtaining relief during recessions, and ensure that firms that obtain an affirmative decision from the International Trade Commission be granted some form of relief;

(5) Authorize U.S. participation in MIGA.

In addition, the Roundtable recommends certain policy initiatives, including implementation of the export control policies adopted by Congress in 1985; continued cooperation with the G-7 on economic, fiscal, monetary issues; appropriate alignment of the dollar relative to other countries, especially some of the NICs; resolution of the third world debt crisis in a manner that promotes sustained growth in trade.

The Business Roundtable recognizes that legislation cannot solve all our trade problems, but it is an important first step.

We very much want to be an active part of the process, working with Congress and the Administration toward a sensible trade bill. You and your staff have been given a copy of the full Roundtable statement that explains these recommendations in more detail. We hope that that paper will add value to the process.

Now, admittedly, these trade issues are complex, but, if our predecessors could do it 40 years ago, why can't we do it now?

I am delighted to be here and would be glad to answer questions.

The CHAIRMAN. Thank you very much, Mr. Robinson.

I will interrupt for just a moment because, as I was mentioning earlier, the competition of responsibilities that we have are such that some of the members cannot stay. And Senator Riegle, who is the Chairman of the Space Subcommittee, is chairing hearings, and has come over to acknowledge his interest, and his concern, and I would like to defer to him at this moment.

Senator RIEGLE. Thank you, Mr. Chairman. I appreciate it. Mr. Robinson, thank you for making this presentation this morning on behalf of the Roundtable. I think, in going through it, it is particularly constructive in its tone and direction, and it will be very helpful to us. And I will have some questions to submit for the record. And I appreciate very much your testimony. And I apologize to Mr. Shepherd that I am going to have to leave to chair this other section. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Mr. ROBINSON. Thank you, Sanator.

The CHAIRMAN. Mr. Shepherd, if you would proceed, please.

[The prepared written statement of Mr. Robinson and the written question of Senator Riegle and answer by Mr. Robinson follow:]

Statement of
James D. Robinson III
Chairman and Chief Executive Officer,
American Express Company
and
Chairman,
The Business Roundtable
Task Force on International Trade and Investment
Before the
Senate Committee on Finance
Hearing on
Mastering the World Economy
Tuesday, February 3, 1987

Mr. Chairman and members of the Committee, I am pleased to participate in these landmark hearings. I am particularly pleased because you have been asking some basic questions: what type of world economy should we be striving for, and how can the United States earn its way in it?

These questions are similar to ones asked in Congress immediately after World War II. At that time, we concluded that the answer was the establishment of a cooperative, multilateral framework for promoting growth -- the IMF, the World Bank and the GATT. Another institution was proposed at the time, the International Trade Organization. It would have set out rules much more extensive than those of the GATT. Unfortunately, it was never created, due to apathy on the part of the business community and opposition from Congress.

A lot has happened over the last forty years. The United States is no longer the sole dominant economy. Europe has developed into a formidable economic rival. Japan has emerged as the world's second largest economic power... and the number one foreign creditor nation. Korea, Taiwan, Singapore and Brazil have become industrial powers in their own right, competing not only in the very industries from which America once derived its economic strength, but also in the new technologies. Even India and China are now well on their way to establishing themselves as major players in the world economy.

The challenge is clear: how can the United States continue to maintain its standard of living at a time when other countries are demanding a greater share of the world pie? How can the United States remain competitive when it is no longer the dominant world producer of many goods and services? How can we expand the size of the world pie and avoid resorting to beggar-thy-neighbor policies?

The answers are not easy. Our nation is facing a set of complex and interrelated problems that significantly impact our competitive position in the world economy:

- We have an enormous domestic budget deficit. That discourages growth and investment at home. The Business Roundtable believes the deficit is the major cause of our trade problems.

- In 1986, the U.S. became a net debtor nation with an external debt that could reach $1 trillion by the early 1990's.

- U.S. productivity in manufacturing is growing at rates slower than those of most developed nations. Between 1979 and 1985, U.S. manufacturing productivity grew at a rate of 3.1 percent, compared to 5.7 percent for Japan and 4.2 percent for the United Kingdom. President Reagan and many members of

Congress have properly challenged our lack of competitiveness.

- A strong dollar has made U.S. manufactured goods less competitive at home and abroad. Although the dollar has depreciated sharply in relation to the yen and the German mark, it remains excessively high vis-a-vis the currencies of many countries, particularly the newly industrialized ones.

- The Third World debt crisis threatens our financial institutions. Austerity programs have forced debtor nations to limit their imports. Between 1981 and the end of 1986, U.S. exports to Third World debtor countries dropped 33 percent, while imports remained virtually unchanged.

- More and more countries are erecting barriers to trade while seeking to expand their own export markets. The 1986 <u>National Trade Estimate on Foreign Trade Barriers</u> includes over 300 pages documenting foreign barriers to trade. Restrictions to trade are costly. In our own country, special protection cost American consumers roughly $54 billion in 1984... more today.

These problems are enormous. But I think there are some things we can do about them. I will list five:

- We need to fix GATT.
- We need to negotiate a free trade agreement with Canada this year.
- We need to focus more on our bilateral relationships, particularly with Japan.
- We need trade legislation this year.
- We need to be tough at the negotiating table.

What are our objectives? First, we want to preserve and promote an open trading system. Why? Like it or not, the growth of the U.S. economy depends importantly on expanding overseas markets. In business we call it growing the primary market; that is, expanding the total pie so we compete for bigger pieces of a bigger pie. World trade is a positive, not a zero sum game.

Second, we need to establish rules to make the open trading system work. The GATT can no longer be used just as a debating society. It must become more relevant and effective. As John Young pointed out in his testimony here, only 15 percent of trade restrictions are covered by any agreed-upon rules. We must adapt GATT to today's trade and investment environment and give it rules and mechanisms that work.

Third, we have to take care of ourselves. We have to defend our own interests if others won't play by the rules. We must be tougher at the negotiating table. Our U.S. Trade Representative is doing just that.

Fourth, we need to be flexible. The world is in a constant state of change. The United States has always thrived on its ability to embrace new ideas, develop new technologies and be entreprenurial. We should encourage these traits. We cannot perpetuate buggy whip industries. At the same time, change brings disruption. We need realistic measures for helping individuals and industries adjust.

Those are some key objectives. How do we achieve them? We achieve them in the GATT negotiations, in bilateral trade agreements, and when necessary, on our own.

First, the GATT. The launching of the new trade round last September was a major step forward. I was a U.S. delegate to the GATT Ministerial meeting in Punta del Este. The U.S. achievements at that meeting were significant. We have considerable leverage and support going into these talks. I believe we can ultimately walk away from the table with agreements that are beneficial to all trading nations, including the United States.

Of course, there are skeptics. Some argue the talks will take too long or that our negotiators lack clear objectives. Others see the GATT as a device to stall or avoid action.

The trade round cannot and should not be a substitute for an aggressive trade policy. But if the total trade pie is to grow, we must have a multilateral framework. The GATT provides that framework, even if an imperfect one. A world without GATT would be worse than New York City without traffic lights.

The U.S. negotiating objectives are clear. Our primary goal should be to make the GATT work. Dispute settlement procedures must be improved. We need a safeguards code that imposes discipline on the use of import relief and encourages adjustment. Procedures for dealing with new forms of subsidies and dumping practices must be negotiated. Finally, and of great importance, we need rules for trade in areas not covered by the GATT including agriculture, services, intellectual property and investment.

Work is already under way. In services, for example, my company, along with other service companies, has been working with the Administration to develop specific goals for an umbrella agreement and for certain sectoral agreements... like telecommunications, tourism, and insurance. Companies interested in intellectual property are also working closely with the Administration.

A major key to the success of the talks is strong and continuing support from Congress and the private sector. The Business Roundtable, and a number of other major business organizations support the new round and its comprehensive agenda. It's time for the Administration to work more closely with Congress and the private sector on this effort. It's also time for Congress to go on record in support of the talks. The U.S. Trade Representative must be given clear objectives and flexible negotiating authority.

What about bilateral negotiations? There an immediate concern is the U.S. Canada free trade talks. The United States and Canada have the largest bilateral trade relationship in the world. Total trade between the countries was $113.2 billion in 1986, with a significant U.S. trade deficit of $23.6 billion. We share a unique geo-political and strategic relationship.

These negotiations are critical. A comprehensive agreement with the Canadians would create a powerful market-oriented free trade zone, rivaled only by the European Community. We have to face the possibility that the E.E.C. may tighten ranks against the rest of the world, and that the GATT negotiations may not succeed. In such a world, the Canadian market would be even more important for the U.S., and vice versa.

If we are successful in Canada, we can use the talks as a model for multilateral agreements in the GATT. An early and comprehensive agreement with Canada could encourage other countries to get down to brass tacks more quickly. If we fail with Canada, our largest trading partner and neighbor, how can we hope to get anywhere in the GATT?

I am disturbed that these free trade talks have not been receiving adequate interest and support in this country. We have an incredible opportunity before us. This Canadian effort deserves great attention and the highest of priorities in the Adminstration and Congress.

That brings me to another bilateral relationship: Japan. In 1986, Japan ran an estimated $60 billion trade surplus with the United States. I suspect it will get bigger before it gets smaller. Obviously, these numbers are of serious concern. In my own view, Japan is making a number of positive changes -- though much remains to be done. Since 1985, the yen has appreciated 40 percent vis-a-vis the dollar. Japan has taken steps to open a number of its markets, including its financial markets. The Maekawa Report, which Prime Minister Nakasone has endorsed, lays out a policy for making the Japanese economy less export oriented over the long term.

Japan has also begun to assume a greater share of its global responsibility by increasing its contribution to the

World Bank, expanding its foreign aid budget, and injecting greater concessionality into its foreign aid programs.

Japan has a major responsibility to use its financial surplus to play a positive role in the global economy. On a personal note, I have been spending a good deal of time talking to Japanese leaders about the critical need for Japan to make a substantial commitment in this area. I believe that just as the United States carries the major burden for the military security of the world, Japan and other chronic trade surplus countries should shoulder major roles in supporting the world's economic security. As George Marshall said forty years ago: "Without normal economic health in the world, there can be no political stability and no assured peace."

The Japanese know they need access to world markets. The Administration, Congress and the U.S. Trade Representative should continue to encourage Japan and other surplus countries like Germany to open their markets to exports, including those of the LDCs. An even more important contribution the Japans and Germanys of the world could make would be to utilize their excess savings and surplus in ways that encourage structural reform in the LDCs. That in turn can lead to opening developing country markets to the benefit of all trading nations.

Finally, I'd like to comment on what we can do now, on our own, to attain these objectives in the trade arena. This gets to the question of legislation. The Business Rountable strongly supports the enactment of trade legislation. We have recently released a comprehensive statement with recommendations for action.

To summarize that statement, The Roundtable recommends that Congress pass legislation to:

1. Authorize the new trade round, with fast track legislative procedures.

2. Transfer authority to take action under Section 301 from the President to the U.S. Trade Representative and strengthen 301 to provide greater certainty in resolution of unfair trade and investment cases.

3. Provide greater protection for intellectual property by eliminating the injury requirement and the domestic industry test from Section 337 cases.

4. Amend Section 201 of the Trade Act to:

   - place more emphasis on adjustment,
   - broaden the scope of adjustment;
   - ease standards for obtaining relief during recessions;

- ensure that firms that are successful in obtaining an affirmative decision from the International Trade Commission be granted some form of relief.

5. Authorize U.S. participation in the Multilateral Investment Guaranty Agency (MIGA).

In addition, The Roundtable recommends certain policy initiatives be undertaken by the U.S. government, including:

- implementation of the export control policies adopted by Congress in the 1985 Amendments to the Export Administration Act.

- continued cooperation with the G-7 on fiscal and monetary issues;

- appropriate alignment of the dollar relative to the currencies of other countries, particularly the NICs;

- resolution of the Third World debt crisis in a manner that promotes sustained growth in trade.

The Business Roundtable recognizes that enactment of legislation will not solve all our trade problems, but it is an important first step. We want very much to be an active participant in working with Congress and the Administration towards a sensible trade bill. You and your staff have been given a copy of The Roundtable statement that explains the recommendations I just mentioned in substantially more detail. We hope it will add value to the process.

In closing, I should say that now, more than ever, we need to think in global terms. Unilateral measures that undermine an open trading system -- regardless of how tempting -- must be resisted. Admittedly, the issues are complex. But if our forefathers could do it forty years ago, certainly we can do it again.

Thank you for the opportunity to be here. I will try to answer any questions you may have.

Mr. Riegle: Mr. Robinson, you stated that the budget deficit is the major cause of our trade problems. I tend to share the belief that over the long run, our budget and trade deficits are inter-related. In fact, the numbers are absolutely alarming and in my view, cannot continue on this trend. However, I don't believe we can exclude the external issues, such as unfair trade practices by our trading partners, an ever-increasing number of players in the world economic game and direct efforts by certain countries and industries to capture our markets.

Don't you think that strong legislation will serve an important purpose in putting Japan and Korea and other countries on notice that we have had enough? Conversely, won't a weaker bill send a message that we're still running business as usual -- talking a good game but not backing it up with anything substantive?

RESPONSE OF JAMES D. ROBINSON III TO QUESTION SUBMITTED BY SENATOR DONALD RIEGLE ON FEBRUARY 3.

Legislation will not, in and of itself, make a significant contribution to reducing the trade deficit. Market barriers are only one part of the problem. Strong trade legislation is an important first step in saying to the rest of the world that trade is a top priority in the U.S., that the U.S. must be tough at the negotiating table, and that we will not tolerate unfair trade practices. The Business Roundtable supports the enactment of strong trade legislation. Our trade statement includes several recommendations which I think would be taken seriously by our trading partners.

STATEMENT OF MR. MARK SHEPHERD, JR., CHAIRMAN, TEXAS INSTRUMENTS, INCORPORATED, DALLAS, TX

Mr. SHEPHERD. Mr. Chairman and members of the committee, I appreciate this opportunity to join with you in trying to develop an agenda for strengthening our ability to compete.

The erosion of our competitiveness in recent years is only a part of the changes that are now sweeping the global economy, and that includes a massive shift in the focus of world economic activity toward the Pacific Basin. While the United States is struggling to regain its leadership position, the nations of the Asia/Pacific region have skillfully exploited their labor-cost and productivity advantages to steadily increase their share of world markets.

The U.S.'s competitive strategy should not rely on forcing our trading partners to give up their legitimate advantages. Instead, we should be tough with those who take advantage of our goodwill and develop a strategy that builds on America's strengths that tip the competitive scales in our favor.

There are three sets of actions that will help to restore our competitiveness, both at home and abroad.

First, we must reduce our budget deficit. Any attempt to lower the trade deficit without making parallel reductions in the budget deficit would dry up demand for U.S. securities, push interest rates higher, and bring the economic expansion to a halt.

Second, we must face the challenge of enhancing the competitiveness of the private sector through measures aimed at: (a) Increasing the availability of capital; (b) Enhancing incentives for research and development; and (c) Improving the skill levels, not only the technical skills, but, more importantly, the basic skills of the work force.

U.S. firms face a cost-of-capital disadvantage of about 2 to 1 with respect to the Japanese. If this disparity is allowed to continue, U.S. companies will not be able to keep up with Japanese investments, and America's technological leadership will continue its erosion.

Unfortunately, the Tax Reform Act of 1986 further increased this cost of capital gap by repealing the investment tax credit and raising the capital gains tax on investment income.

Future legislation should consider ways of enhancing the incentives for personal savings and for capital formation. By repealing taxes on interest from savings, eliminating the double taxation of dividends, by lowering tax rates on capital gains, and by reenacting portions of the investment tax credit.

Consideration should be given to a consumption tax as an offset to tax revenues lost through those reforms.

Research and development. The United States still leads the world in the absolute commitment of funds to basic research, but we have been weak in executing the difficult transition from R&D prototypes to full scale commercial production. The development of manufacturing equipment and processes to make this transition often requires more complex technology than the product development itself.

The Japanese recognized this some time ago, and they have stressed the importance of this critical phase of innovation, and they have committed substantial resources to this area. As a result, they are beating us with their ability to take ideas into full scale production in only about half the time we require and often with lower manufacturing costs.

While there is no single solution to this problem, a concerted effort on the part of industry and government could create the conditions necessary to aid us.

Industry must focus management's attention towards the importance of manufacturing. An essential element in the revival of the U.S. industrial sector is infusion of a stronger manufacturing culture in board rooms and executive offices across the country. The government, in turn, should take some actions to encourage R&D activities.

First, the R&D tax credit should be made permanent since its current temporary nature makes it difficult to plan long-range projects.

Second, the impact of the R&D credit should be enhanced by restoring the 25 percent rate that existed prior to the Tax Reform Act of 1986.

I am pleased that several members of this committee have joined with Senator Danforth in introducing Senate bill 58, the Research and Development Incentive Act, which, if enacted, will accomplish each of these recommendations. But we should go a step further.

Eligibility for R&D tax credits should be expanded to include the broad range of expenses involved in developing and implementing innovative manufacturing processes, machinery and facilities.

And, finally, by requiring allocation of domestic R&D expenditures to foreign-source income, current tax law provides incentives for American multinational companies to move R&D activities abroad.

Congress should enact a permanent moratorium against implementation of such R&D allocations under Treasury regulations.

The potential offered by technology-intensive industries can be fully realized only when society has a broad educational base as well as a high level of technological literacy.

Academia must work with industry to encourage more high school students to pursue engineering and science by giving them an understanding of the opportunities open to those with a first-class technical education.

We should emphasize co-operative programs that allow students to earn the money required to pursue an engineering or science degree, and we should develop curricula that support life-long education for self-renewal.

More attention must be given to basic education, especially in math and science. To restore the effectiveness of American schools, we need deeper family involvement and a strong national commitment to higher educational standards. To this end, the federal government should recommend minimum standard requirements to state and local school boards.

The third set of actions that will help us hinges on the execution of an aggressive U.S. trade policy.

Under the umbrella of a national trade policy, we should pursue a variety of goals aimed at lowering trade barriers; facilitating trade in services; enforcing intellectual property rights; and mitigating chronic currency imbalances.

The U.S. should bring pressure on our trading partners to provide our exporters with the same opportunities that we offer to others. And in particular, Japan could reduce conflicts with its major trading partners by implementing the recommendations of the Maekawa Report. But we should not be misled. Opening Japan's markets will not cure our bilateral trade deficit. At most, it would reduce it by 10 or 15 billion dollars. And even if the Japanese were to implement the structural changes promised by the Nakasone Administration, the competitive battle would not be over. It would only move to other countries.

A major issue is how to minimize the impact of the growing restrictions on trade in services.

Although services represent approximately 20 percent of world trade, there are almost no hard data on service trade that could serve as a basis for making policy or measuring its impact.

Currently, nations can discriminate against service trade as anarchy reigns.

The U.S. must push for full coverage of service trade in the upcoming GATT rounds.

A very strategic issue is how to safeguard our hard won technology from the actions of countries that are trampling over our intellectual property rights in a stampede to gain market share.

America's competitive advantage in innovation is seriously threatened by countries that acquire technology through counterfeiting, patent infringement, and other forms of piracy, and then combine that technology with low-cost labor, in many cases to drive the original developers out of the market.

If this practice is allowed to continue, not only will U.S. industry suffer, but the progress of technology development itself may well stall out.

As we have discussed, our country faces a variety of problems ranging from high cost of capital to low educational standards. But we must recognize that the very recent nature of the deterioration in our trade balance is a strong indication that neither American labor nor American management should be accused of being the only cause of our trade deficit. The basic character of America's industry cannot have changed so radically in the brief span of five or six years.

Rather, we should look at the distortions in exchange rates as one of the more important reasons for our deteriorating trade imbalance. The extreme undervaluation of the yen in the first half of the 1980's is well documented.

Today, Taiwanese and Korean exports to the United States are boosted by currencies that are grossly undervalued: In the case of Korea, we believe by more than 60 percent with respect to the dollar.

And Korea and Taiwan are only part of larger problems of increased volatility, lack of predictability for planning purposes, and persistent long-term misalignments of currencies in the present system of flexible exchange rates.

To address these problems, the United States should take the lead in establishing a new system of target zones for major international currencies. The success of a European monetary system suggests that the idea of target zones might be appropriate on a broader scale.

The new system would require the identification and periodic revision of a zone, perhaps 20 percent wide, outside of which rates would be considered in clear disequilibrium. Concerted intervention on the part of major economic powers, followed by changes in interest rates if necessary, would discourage exchange rates from straying outside of the target zones.

In this global economy—and that is indeed what it is—no nation can long remain complacent. And it is time for American ingenuity to come to bear on the problem with international competitiveness.

A strong undercurrent of the traditional American value I believe is still with us. We have an adequate supply of spirit, of goodness and of patriotism, and the high value placed upon freedom, at home as well as abroad. But in these changing times, our traditional values must be blended with new values: a zeal for winning; a firm belief in fiscal responsibility; a determined effort to filter our nation's resources towards productivity and investment; a strong commitment in favor of rebuilding an educational system that is second to none; a revival of the American work effort; a resolve to be tough with those who do not follow the rules of international trade; and a firm determination to manage our own destiny.

Together, the old and the new can form a strong foundation that American society will need to successfully meet the challenges of the coming years ahead.

Thank you, Mr. Chairman.

[The prepared written statement of Mr. Shepherd follows:]

STATEMENT OF

MARK SHEPHERD, JR.
CHAIRMAN
TEXAS INSTRUMENTS INCORPORATED

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

WASHINGTON, D.C.

FEBRUARY 3, 1987

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE: I APPRECIATE THIS OPPORTUNITY TO JOIN WITH YOU IN DEVELOPING AN AGENDA FOR STRENGTHENING AMERICA'S ABILITY TO COMPETE IN DOMESTIC AND INTERNATIONAL MARKETS.

* * *

THE EROSION OF AMERICAN COMPETITIVENESS IN RECENT YEARS IS ONLY A PART OF CHANGES NOW SWEEPING THE GLOBAL ECONOMY, INCLUDING A MASSIVE SHIFT IN THE FOCUS OF WORLD ECONOMIC ACTIVITY TOWARD THE PACIFIC BASIN.[*1] WHILE THE U.S. IS STRUGGLING TO REGAIN ITS LEADERSHIP POSITION, THE NATIONS OF THE ASIA/PACIFIC REGION HAVE SKILLFULLY EXPLOITED THEIR LABOR-COST AND PRODUCTIVITY ADVANTAGES[2] TO STEADILY INCREASE THEIR SHARE OF WORLD MARKETS.[3]

*1 See Notes in Appendix 1. Appendix II is a summary of the major recommendations contained in the testimony.

PRODUCTIVITY IS THE KEY TO A COUNTRY'S COMPETITIVENESS. SINCE 1960, JAPAN'S PRODUCTIVITY GAINS IN MANUFACTURING HAVE INCREASED SIXFOLD RELATIVE TO THE UNITED STATES, AND EUROPE HAS OUTSTRIPPED THE U.S. BY A FACTOR OF TWO.[4] THIS LOWER U.S. PRODUCTIVITY GROWTH HAS RESULTED IN REDUCED PROFIT MARGINS[5], FLAT PRODUCTION[6], DOWNSIZED CAPACITY IN TERMS OF BOTH CAPITAL AND LABOR[7], AND AN INCREASING LOSS OF MARKET SHARE TO IMPORTS.

IN 1980, TOTAL IMPORT PENETRATION OF U.S. DURABLE GOODS MARKETS WAS 26%; TODAY IT IS 34%. THE LOSS OF MARKET SHARE HAS BEEN EVEN MORE RAPID IN HIGH-TECH INDUSTRIES. FOREIGN PENETRATION OF THE U.S. COMPUTER MARKET HAS INCREASED FROM 3% TO 29% IN LESS THAN SIX YEARS.[8]

THESE TRENDS ARE WORRISOME FOR A NATION ACCUSTOMED TO CARRYING THE BANNER OF WORLD ECONOMIC LEADERSHIP.

AMERICA'S COMPETITIVE STRATEGY SHOULD NOT RELY ON FORCING OUR TRADING PARTNERS TO GIVE UP THEIR LEGITIMATE ADVANTAGES. INSTEAD, WE SHOULD BE TOUGH WITH THOSE WHO TAKE ADVANTAGE OF OUR GOOD WILL; AND WE SHOULD DEVELOP A STRATEGY THAT BUILDS ON AMERICA'S STRENGTHS TO TIP THE COMPETITIVE SCALES IN OUR FAVOR.

THERE ARE THREE SETS OF ACTIONS THAT WILL HELP TO RESTORE THE COMPETITIVENESS OF AMERICAN BUSINESS, AT HOME AND ABROAD.

1. REDUCE THE BUDGET DEFICIT.

FIRST, WE MUST REDUCE OUR BUDGET DEFICIT. MASSIVE FEDERAL BUDGET DEFICITS TEND TO EXACERBATE OUR TRADE PROBLEMS IN TWO WAYS: BY CREATING EXCESS DOMESTIC DEMAND WHICH SPILLS OVERSEAS AND ABSORBS MORE IMPORTS, AND BY INCREASING THE PREMIUM ON U.S. INTEREST RATES AND RAISING THE VALUE OF THE DOLLAR. THE OVERVALUATION OF THE DOLLAR IN THE FIRST HALF OF THIS DECADE HAS PRICED OUR EXPORTS OUT OF WORLD MARKETS WHILE ENABLING FOREIGN COMPETITORS TO ESTABLISH A BEACHHEAD IN THE U.S. MARKET?

THE U.S. MUST REDUCE THE SIZE OF THE BUDGET DEFICIT BY REDUCING GOVERNMENT SPENDING TO LEVELS EQUIVALENT TO THOSE OF THE LATE 1960s WHEN TOTAL GOVERNMENT SPENDING WAS ABOUT 20% OF GNP DESPITE DEFENSE REQUIREMENTS THAT ABSORBED MORE THAN 9% OF GNP.[10] WE DON'T SUGGEST THAT DEFENSE SPENDING SHOULD GO BACK TO 9% OF GNP BUT WE STRONGLY RECOMMEND TO USE THE SAME KIND OF RESTRAINT ON NON-DEFENSE SPENDING THAT HAS SERVED US SO WELL THROUGHOUT MOST OF OUR HISTORY.

ANY ATTEMPT TO LOWER THE TRADE DEFICIT WITHOUT MAKING PARALLEL REDUCTIONS IN THE BUDGET DEFICIT WOULD DRY UP DEMAND FOR U.S. SECURITIES, PUSH INTEREST RATES HIGHER, AND BRING THE ECONOMIC EXPANSION TO A HALT.

71-855 O - 87 - 2

2. ENHANCE MANUFACTURING COMPETITIVENESS

SECOND, WE MUST FACE THE CHALLENGE OF ENHANCING THE COMPETITIVENESS OF THE PRIVATE SECTOR THROUGH MEASURES AIMED AT:

A. INCREASING THE AVAILABILITY OF CAPITAL;

B. ENHANCING INCENTIVES FOR RESEARCH AND DEVELOPMENT, BOTH FOR NEW PRODUCTS AND FOR ADVANCED MANUFACTURING PROCESSES AND EQUIPMENT; AND

C. IMPROVING THE SKILL LEVELS -- NOT ONLY THE TECHNICAL SKILLS, BUT ALSO, AND MORE IMPORTANTLY, THE BASIC SKILLS -- OF THE WORK FORCE.

A. CAPITAL

U.S. FIRMS FACE A COST-OF-CAPITAL DISADVANTAGE OF 2 TO 1 WITH RESPECT TO THE JAPANESE, AND 1.3 TO 1 WITH RESPECT TO THE GERMANS.[11]

HIGH SAVINGS RATES IN JAPAN, AND CLOSE TIES BETWEEN BANKS AND INDUSTRY, HAVE FAVORED HIGHLY LEVERAGED FINANCIAL STRUCTURES. DESPITE RECENT TRENDS TOWARD LESS RELIANCE ON DEBT, JAPANESE FIRMS CONTINUE TO EXPLOIT THE LOW COST OF DEBT WITH DEBT-TO-EQUITY RATIOS THAT ARE AT LEAST TWICE AS HIGH AS COMPARABLE RATIOS IN THE UNITED STATES.[12]

ADDITIONALLY, JAPANESE COMPANIES BENEFIT FROM A TAX SYSTEM THAT EFFECTIVELY EXEMPTS FROM TAXATION MUCH DIVIDEND INCOME, INTEREST INCOME AND CAPITAL GAINS ON STOCK. THE RESULT IS THAT EVEN IF DEBT/EQUITY RATIOS WERE THE SAME IN JAPAN AND THE U.S., THE JAPANESE WOULD STILL ENJOY A COST-OF-CAPITAL ADVANTAGE.[13]

LOWER COST-OF-CAPITAL -- AND DIFFERENT EARNING STANDARDS OF THE FINANCIAL COMMUNITY -- HAVE ALLOWED JAPANESE FIRMS TO SATISFY THEIR INVESTORS WITH ONLY 1 OR 2 PERCENT AFTER-TAX PROFIT ON SALES, AS OPPOSED TO THE 5 OR 6 PERCENT REQUIRED IN THE U.S.[14] THIS DIFFERENCE IN ACCEPTABLE PROFIT MARGINS MEANS MORE CASH AVAILABLE TO OUR JAPANESE COMPETITORS FOR ADDITIONAL CAPITAL INVESTMENT AND RESEARCH.[15]

IF THIS DISPARITY IS ALLOWED TO CONTINUE, U.S. COMPANIES WILL NOT BE ABLE TO KEEP UP WITH JAPANESE INVESTMENTS, AND AMERICA'S TECHNOLOGICAL LEADERSHIP WILL CONTINUE ITS EROSION.

THE TAX REFORM ACT OF 1986 FURTHER INCREASED THIS COST-OF-CAPITAL GAP BY REPEALING THE INVESTMENT TAX CREDIT AND RAISING THE CAPITAL GAINS TAX ON INVESTMENT INCOME. THE EFFECT OF THIS LEGISLATION, ACCORDING TO A RECENT STUDY BY TWO ECONOMISTS AT STANFORD UNIVERSITY, DOUGLAS BERNHEIN AND JOHN SHOVEN, WILL BE TO INCREASE THE INFLATION-ADJUSTED COST OF CAPITAL IN THE U.S. BY AT LEAST 30%. THIS WILL WORSEN THE COST-OF-CAPITAL DISADVANTAGE OF U.S. FIRMS WITH RESPECT TO THEIR JAPANESE COMPETITORS FROM 2:1 TO 2.6:1.[16]

[16] See Note #11.

FUTURE LEGISLATION SHOULD CONSIDER WAYS OF ENHANCING THE INCENTIVES FOR PERSONAL SAVING AND FOR CAPITAL FORMATION BY REPEALING TAXES ON THE INTEREST FROM SAVINGS, BY ELIMINATING THE DOUBLE TAXATION OF DIVIDENDS, BY LOWERING TAX RATES ON CAPITAL GAINS AND, ABOVE ALL, BY REINSTATING THE INVESTMENT TAX CREDIT. CONSIDERATION SHOULD BE GIVEN TO A CONSUMPTION TAX AS AN OFFSET TO TAX REVENUES LOST THROUGH REFORM.[17]

B. MANUFACTURING TECHNOLOGIES

MANY HAVE SUGGESTED THAT HIGH-TECHNOLOGY INDUSTRY COULD TAKE UP THE SLACK CAUSED BY THE DECLINE OF AMERICA'S OTHER MANUFACTURING INDUSTRIES. EVEN THOUGH THE RATE OF GROWTH IN TECHNOLOGY-INTENSIVE INDUSTRIES IS HIGHER THAN IN THE TRADITIONAL GOODS-PRODUCING SECTOR,[18] THE ABSOLUTE LEVELS OF OUTPUT AND EMPLOYMENT IN HIGH-TECHNOLOGY INDUSTRIES ARE NOT ENOUGH TO OFFSET THE IMPACT OF DECLINES IN OTHER MANUFACTURING AREAS.[19] A MUCH GREATER ECONOMIC BENEFIT WILL BE REALIZED IF WE BEGIN TO THINK OF HIGH TECHNOLOGY NOT AS AN INDUSTRY, BUT AS A POWERFUL SET OF TOOLS THAT CAN REVITALIZE OUR TRADITIONAL INDUSTRIES.

TECHNOLOGICAL PROGRESS HAS BEEN THE DRIVING FORCE BEHIND MOST OF THE PRODUCTIVITY GAINS WE HAVE MADE IN THIS COUNTRY -- AND THE U.S. STILL LEADS THE WORLD IN THE ABSOLUTE COMMITMENT OF FUNDS TO BASIC RESEARCH.[20] BUT WE HAVE BEEN WEAK IN EXECUTING THE DIFFICULT TRANSITION FROM R&D PROTOTYPE TO FULL-SCALE COMMERCIAL PRODUCTION. THE DEVELOPMENT OF MANUFACTURING EQUIPMENT AND PROCESSES TO MAKE THIS TRANSITION OFTEN REQUIRES MORE COMPLEX TECHNOLOGY THAN THE PRODUCT DEVELOPMENT ITSELF.

THE JAPANESE RECOGNIZED SOME TIME AGO THE IMPORTANCE OF THIS CRITICAL PHASE OF INNOVATION, AND THEY HAVE COMMITTED SUBSTANTIAL RESOURCES TO THIS AREA.[21] AS A RESULT, THEY ARE BEATING US WITH THEIR ABILITY TO TAKE IDEAS INTO FULL-SCALE PRODUCTION IN ONLY HALF THE TIME WE REQUIRE[22] AND OFTEN WITH LOWER MANUFACTURING COSTS.

WHILE THERE IS NO SINGLE SOLUTION TO THIS PROBLEM, CONCERTED EFFORT ON THE PART OF INDUSTRY AND GOVERNMENT COULD CREATE THE CONDITIONS NECESSARY TO TRANSLATE BASIC RESEARCH INTO USEFUL PRODUCTS.

INDUSTRY MUST FOCUS MANAGEMENT ATTENTION TOWARD THE IMPORTANCE OF MANUFACTURING ITSELF, AND THE INTERACTION BETWEEN MANUFACTURING AND ALL OTHER ASPECTS OF A BUSINESS. AN ESSENTIAL ELEMENT IN THE REVIVAL OF THE U.S. INDUSTRIAL SECTOR IS THE INFUSION OF A STRONGER MANUFACTURING CULTURE IN BOARDROOMS AND EXECUTIVE OFFICES ACROSS THE COUNTRY, AND THE DEVELOPMENT OF STRATEGIC PLANS THAT INCORPORATE MANUFACTURING AS AN INTEGRAL PART OF A TOTAL BUSINESS STRATEGY.[23]

THE GOVERNMENT, IN TURN, SHOULD TAKE SEVERAL ACTIONS TO ENCOURAGE RESEARCH & DEVELOPMENT ACTIVITIES AND PROVIDE U.S. FIRMS WITH THE CASH FLOW NECESSARY TO PURSUE THE DEVELOPMENT OF ADVANCED MANUFACTURING TECHNOLOGIES.

- FIRST, THE R&D TAX CREDIT SHOULD BE MADE PERMANENT, SINCE ITS CURRENT TEMPORARY NATURE MAKES IT DIFFICULT TO PLAN LONG-RANGE PROJECTS. R&D CREDITS ARE FAR PREFERABLE TO DIRECT GOVERNMENT FUNDING BECAUSE THEY LET THE MARKETPLACE DETERMINE WHERE THE MONEY GOES.[24]

- SECOND, THE IMPACT OF THE R&D CREDIT SHOULD BE ENHANCED BY RESTORING THE 25% RATE THAT EXISTED PRIOR TO THE TAX REFORM ACT OF 1986.[25] I AM PLEASED THAT SEVERAL MEMBERS OF THIS COMMITTEE HAVE JOINED WITH SENATOR DANFORTH IN INTRODUCING SENATE BILL 58 -- THE RESEARCH AND DEVELOPMENT INCENTIVE ACT -- WHICH, IF ENACTED, WILL ACCOMPLISH EACH OF THESE RECOMMENDATIONS. BUT WE SHOULD GO A STEP FURTHER. . .

- ELIGIBILITY FOR R&D TAX CREDITS SHOULD BE EXPANDED TO INCLUDE THE BROAD RANGE OF EXPENSES INVOLVED IN DEVELOPING AND IMPLEMENTING INNOVATIVE MANUFACTURING PROCESSES, INCLUDING THE COST OF MACHINERY AND FACILITIES WHICH RESULT FROM R&D ACTIVITIES.[26]

- FINALLY, BY REQUIRING ALLOCATION OF DOMESTIC R&D EXPENDITURES TO FOREIGN-SOURCE INCOME, CURRENT TAX LAW PROVIDES INCENTIVES FOR AMERICAN MULTINATIONAL COMPANIES TO MOVE R&D ACTIVITIES ABROAD WHERE THESE EXPENDITURES ARE FULLY DEDUCTIBLE. THIS DISPLACEMENT TRANSFERS THE INHERENT BENEFITS OF R&D TO OTHER ECONOMIES AND CONTRIBUTES TO THE SHORTAGE OF TECHNICALLY TRAINED PERSONNEL IN THE U.S. CONGRESS SHOULD ENACT A PERMANENT MORATORIUM AGAINST IMPLEMENTATION OF SUCH R&D ALLOCATIONS UNDER TREASURY REGULATIONS (1.861-8).[27]

C. EDUCATION

THE POTENTIAL OFFERED BY TECHNOLOGY-INTENSIVE INDUSTRIES CAN BE FULLY REALIZED ONLY WHEN SOCIETY HAS A BROAD EDUCATIONAL BASE AS WELL AS A HIGH LEVEL OF TECHNOLOGICAL LITERACY.

ACADEMIA MUST WORK WITH INDUSTRY TO INCREASE THE CAPACITY OF OUR TECHNICAL EDUCATION SYSTEM, IN ORDER TO ALLEVIATE THIS COUNTRY'S TECHNICAL MANPOWER SHORTAGE.[28] TO CLOSE THIS GAP, WE NEED TO:

- ENCOURAGE MORE HIGH-SCHOOL STUDENTS TO PURSUE ENGINEERING AND SCIENCE BY GIVING THEM AN UNDERSTANDING OF THE OPPORTUNITIES OPEN TO THOSE WITH FIRST-CLASS TECHNICAL EDUCATIONS.

- EMPHASIZE CO-OP PROGRAMS THAT ALLOW A STUDENT TO EARN THE MONEY REQUIRED TO PURSUE AN ENGINEERING DEGREE AND, MORE IMPORTANTLY, PROVIDE THE STUDENT WITH VALUABLE INDUSTRY AND PEOPLE EXPERIENCE.

- ENCOURAGE THE GROWING INTEREST OF WOMEN IN ENGINEERING DISCIPLINES.

- AND, DEVELOP CURRICULA THAT SUPPORT LIFELONG EDUCATION FOR SELF-RENEWAL.

MORE ATTENTION MUST BE GIVEN TO BASIC EDUCATION, ESPECIALLY IN MATH AND SCIENCE.

STUDENTS IN JAPAN'S PRIMARY AND SECONDARY SCHOOL SYSTEM BENEFIT BY HAVING:

- PARENTS WHO ACTIVELY PROMOTE LEARNING BY COOPERATING WITH TEACHERS, SUPERVISING EXTENSIVE HOMEWORK AND NOT ACCEPTING MEDIOCRE PERFORMANCE;

- TEACHERS WHO ARE WELL QUALIFIED AND HIGHLY MOTIVATED BECAUSE OF THE PAY AND THE RESPECT ACCORDED TO THEM;[29] AND

- A SCHOOL YEAR THAT IS 30 PERCENT LONGER THAN IN THE U.S. (240 DAYS VS. 180 DAYS AVERAGE).[30]

TO RESTORE THE EFFECTIVENESS OF AMERICAN SCHOOLS, WE NEED TO PROVIDE THE NECESSARY FINANCIAL INCENTIVES TO ATTRACT AND RETAIN EXCELLENT TEACHERS. WE ALSO NEED DEEPER FAMILY INVOLVEMENT AND A STRONG NATIONAL COMMITMENT TO HIGHER EDUCATIONAL STANDARDS. TO THIS END, THE FEDERAL GOVERNMENT SHOULD RECOMMEND MINIMUM STANDARD REQUIREMENTS TO STATE AND LOCAL SCHOOL BOARDS.

3. FORMULATE AN AGGRESSIVE TRADE POLICY.

THE THIRD SET OF ACTIONS THAT WILL HELP RESTORE THE COMPETITIVENESS OF AMERICAN BUSINESSES HINGES ON THE EXECUTION OF AN AGGRESSIVE U.S. TRADE POLICY.

THE U.S. LACKS A COHERENT, UNIFIED POLICY PROMOTING TRADE. THE GROWING IMPORTANCE OF INTERNATIONAL TRADE TO THE U.S. COMPELS US TO STRENGTHEN TRADE LAWS TO DEAL EFFECTIVELY WITH UNFAIR TRADE PRACTICES, TO REMOVE DOMESTIC BARRIERS TO EXPORTS[31] AND TO ACTIVELY PROMOTE TRADE BY INCREASING THE FLOW OF CRITICAL INFORMATION ABOUT EXPORT OPPORTUNITIES.

UNDER THE UMBRELLA OF A NATIONAL TRADE POLICY, WE SHOULD PURSUE A VARIETY OF GOALS AIMED AT:

- LOWERING TRADE BARRIERS;
- FACILITATING TRADE IN SERVICES;
- ENFORCING INTELLECTUAL PROPERTY RIGHTS; AND
- MITIGATING CHRONIC CURRENCY IMBALANCES.

A. Reduce trade barriers to U.S. products.

Increasingly, trade restrictions have taken the form of non-tariff barriers such as voluntary export restraints and quotas. It is estimated that between 80 and 90 percent of international trade today is conducted <u>outside</u> the framework of the General Agreement on Tariffs and Trade.[32] Non-tariff barriers are particularly harmful since they are difficult to quantify, and once in place are almost impossible to remove.

The U.S. should bring pressure on our trading partners to provide our exporters the same opportunities that we offer to others. In particular, Japan could reduce conflicts with major trading partners by implementing the recommendations of the Maekawa Report.[33] This would require a greater willingness to import foreign products when they are truly competitive in price and quality, and a transformation of Japan's economy to growth based on domestic demand.

BUT WE SHOULD NOT BE MISLED: OPENING JAPAN'S MARKETS WOULD NOT CURE OUR BILATERAL TRADE DEFICIT. AT MOST, IT WOULD REDUCE IT BY $10 OR $15 BILLION DOLLARS.[34] EVEN IF THE JAPANESE WERE TO IMPLEMENT THE STRUCTURAL CHANGES PROMISED BY THE NAKASONE ADMINISTRATION, THE COMPETITIVE BATTLE WOULD NOT BE OVER; IT WOULD ONLY SHIFT TO OTHER COUNTRIES. TAIWAN, KOREA, SINGAPORE, AND HONG KONG, ARE ALREADY POWERFUL FORCES IN WORLD MARKETS. IN TIME, INDIA AND CHINA WILL BE STRONG COMPETITORS.

B. FACILITATE TRADE IN SERVICES.

A MAJOR STRATEGIC ISSUE FACING MULTINATIONAL COMPANIES IS HOW TO MINIMIZE THE IMPACT OF THE GROWING RESTRICTIONS ON TRADE IN SERVICES.

ALTHOUGH SERVICES REPRESENT APPROXIMATELY 20% OF WORLD TRADE,[35] THERE ARE ALMOST NO HARD DATA ON SERVICE TRADE THAT COULD SERVE AS A BASIS FOR MAKING POLICY OR MEASURING ITS IMPACT. CURRENTLY, NATIONS CAN, AND DO, DISCRIMINATE AGAINST SERVICE TRADE AS ANARCHY REIGNS SUPREME. AS A RESULT, SERVICE TRADE BARRIERS HAVE MUSHROOMED AND AMERICA'S TRADE SURPLUS IN SERVICES HAS WEAKENED (FROM $42 BILLION IN THE EARLY 1980S TO $22 BILLION IN 1985).[36]

THE DECLINE IN SERVICE TRADE IS WORRISOME BECAUSE OUR ABILITY TO COMPETE IN SERVICES ENHANCES OUR ABILITY TO COMPETE IN GOODS -- AND VICE VERSA.[37] THE U.S. MUST PUSH FOR FULL COVERAGE OF SERVICE TRADE IN THE UPCOMING GATT ROUNDS.[38]

C. INCREASE PROTECTION OF INTELLECTUAL PROPERTY RIGHTS.

ANOTHER STRATEGIC ISSUE IS HOW TO SAFEGUARD OUR TECHNOLOGY FROM THE ACTIONS OF COUNTRIES THAT ARE TRAMPLING OVER INTELLECTUAL PROPERTY RIGHTS IN THE STAMPEDE TO GAIN MARKET SHARE.[39] AMERICA'S COMPETITIVE ADVANTAGE IN INNOVATION IS SERIOUSLY THREATENED BY COUNTRIES THAT ACQUIRE TECHNOLOGY THROUGH COUNTERFEITING, PATENT INFRINGEMENT, AND OTHER FORMS OF PIRACY, AND THEN COMBINE THAT TECHNOLOGY WITH LOW-COST LABOR TO DRIVE THE ORIGINAL DEVELOPERS OUT OF THE MARKET.

IF THIS PRACTICE IS ALLOWED TO CONTINUE, NOT ONLY WILL U.S. INDUSTRY SUFFER, BUT THE PROGRESS OF TECHNOLOGY DEVELOPMENT ITSELF WILL BE STALLED.

THE U.S. HAS TRADITIONALLY BEEN THE CHAMPION OF FREE TRADE. BUT AMERICA CANNOT REMAIN THE DUMPING GROUND OF OTHER MANUFACTURING NATIONS -- NOR SHOULD IT CONTINUE TO BE THE VICTIM OF GOVERNMENT SUBSIDIES BY ITS COMPETITORS.

PREVENTION OF DUMPING -- AND THE PAYMENT OF A FAIR PRICE FOR THE USE OF INTELLECTUAL PROPERTY -- ARE ESSENTIAL FOR ASSURING THE CONTINUED DEVELOPMENT OF INNOVATIVE TECHNOLOGIES AND PRODUCTS.

THE RECENT U.S.-JAPAN SEMICONDUCTOR TRADE AGREEMENT WAS INTENDED TO SERVE AS A MECHANISM FOR OPENING THE SEMICONDUCTOR MARKET IN JAPAN TO FAIR COMPETITION FROM U.S. COMPANIES, AND FOR ENSURING THAT JAPANESE FIRMS ABIDE BY BOTH THE U.S. AND GATT ANTI-DUMPING RULES.[40] OUR GOVERNMENT REPRESENTATIVES -- SECRETARIES MAC BALDRIGE AND BRUCE SMART AT COMMERCE AND AMBASSADORS CLAYTON YEUTTER AND MIKE SMITH AT USTR -- WORKED TIRELESSLY TO REACH AGREEMENT WITH THE GOVERNMENT OF JAPAN, AND, DURING THE INTERVENING MONTHS HAVE CONTINUED NEGOTIATIONS SEEKING TO INSURE EFFECTIVE ENFORCEMENT.

TO DATE, UNFORTUNATELY, PROGRESS TOWARD THE GOALS OF INCREASED ACCESS TO THE JAPANESE MARKET AND A HALT TO THE DUMPING OF SEMICONDUCTORS IN WORLD MARKETS HAS BEEN MINIMAL.

NONETHELESS, THE AGREEMENT SETS THE PROPER PRECEDENT FOR AMERICAN TRADE POLICY -- IT TELLS JAPAN THAT THE U.S. GOVERNMENT WILL GUARD EFFICIENT INDUSTRIES FROM UNFAIR COMPETITION AND IT TELLS THE AMERICAN PUBLIC THAT THERE ARE ALTERNATIVES TO PROTECTIONISM. THUS, I ENCOURAGE OUR GOVERNMENT NEGOTIATORS TO REMAIN STEADFAST IN THEIR DETERMINATION TO SEE THAT THE AGREEMENT LIVES UP TO ITS INTENDED PURPOSES.

D. REDRESS CHRONIC CURRENCY IMBALANCES.

AS DISCUSSED, OUR COUNTRY FACES A VARIETY OF PROBLEMS RANGING FROM HIGH COST OF CAPITAL TO LOW EDUCATIONAL STANDARDS. BUT WE MUST RECOGNIZE THAT THE VERY RECENT NATURE OF THE DETERIORATION IN OUR TRADE BALANCE IS A STRONG INDICATION THAT NEITHER AMERICAN LABOR NOR AMERICAN MANAGEMENT SHOULD BE ACCUSED OF BEING THE ONLY CAUSE OF OUR TRADE DEFICIT. THE BASIC CHARACTER OF AMERICA'S INDUSTRY CANNOT HAVE CHANGED SO RADICALLY IN THE BRIEF SPAN OF FIVE OR SIX YEARS.

Rather, we should look at distortions in exchange rates as one of the more important reasons for our deteriorating trade imbalance. The extreme undervaluation of the yen in the first half of the 1980s is well documented. Today, Taiwanese and Korean exports to the U.S. are boosted by currencies that are grossly undervalued -- in Korea's case by more than 60 percent -- with respect to the dollar.[41] These relative currency values do not reflect the true positions of Taiwan and Korea in world markets. The use of more realistic trade weights in computing the value of their currencies, instead of the current policy of pegging them exclusively to the dollar, would go a long way toward eliminating this distortion.

KOREA AND TAIWAN ARE ONLY PART OF LARGER PROBLEMS OF INCREASED SHORT-TERM VOLATILITY, LACK OF PREDICTABILITY FOR PLANNING PURPOSES, AND PERSISTENT LONG-TERM MISALIGNMENTS OF CURRENCIES IN THE PRESENT SYSTEM OF FLEXIBLE EXCHANGE RATES. THE PROPONENTS OF THE CURRENT SYSTEM BELIEVED THE VALUES OF CURRENCIES WOULD BE SET IN THE MARKET FOR TRADED GOODS. BUT NO ONE FORESAW THE VAST AMOUNT OF CAPITAL THAT WOULD BE MOVING ACROSS BORDERS, OVERPOWERING THE FLOW OF GOODS.

IN TODAY'S MARKETS, THE FLOW OF CAPITAL IS 18 TIMES THE FLOW OF GOODS.[42] AS A RESULT, EXCHANGE RATES TEND TO BE SET IN THE FINANCIAL MARKETS, OR BY GOVERNMENTS, WITHOUT REGARD TO THE UNDERLYING CHANGES IN INFLATION AND PRODUCTIVITY THAT DETERMINE A NATION'S COMPETITIVE POSITION.

TO ADDRESS THESE PROBLEMS, THE U.S. SHOULD TAKE THE LEAD IN ESTABLISHING A NEW SYSTEM OF TARGET ZONES FOR MAJOR INTERNATIONAL CURRENCIES.[43] THE SUCCESS OF THE EUROPEAN MONETARY SYSTEM SUGGESTS THAT THE IDEA OF TARGET ZONES MIGHT BE APPROPRIATE ON A BROADER SCALE.

THE NEW SYSTEM WOULD REQUIRE THE IDENTIFICATION (AND PERIODIC REVISION) OF A ZONE, PERHAPS 20% WIDE, OUTSIDE OF WHICH RATES WOULD BE CONSIDERED IN CLEAR DISEQUILIBRIUM. CONCERTED INTERVENTION ON THE PART OF MAJOR ECONOMIC POWERS, FOLLOWED BY CHANGES IN INTEREST RATES IF NECESSARY, WOULD DISCOURAGE EXCHANGE RATES FROM STRAYING OUTSIDE THEIR TARGET ZONES. THIS SYSTEM WOULD:

A. REQUIRE GOVERNMENTS TO CONSIDER EXPLICITLY THE EFFECTS OF NATIONAL ECONOMIC POLICIES ON INTERNATIONAL COMPETITIVENESS;

B. ENCOURAGE PRODUCTIVE INVESTMENT BY PROVIDING A MORE STABLE FINANCIAL ENVIRONMENT; AND

c. Prevent the type of 'beggar thy neighbor' policies employed by countries with chronically undervalued currencies.

Conclusions

In this global economy, no nation can long remain complacent or afford to make many mistakes. It is time for American ingenuity to come to bear on the problem of international competitiveness.

A strong undercurrent of the traditional American values is still with us. There is no lack of spirit, of goodness, of patriotism; and the high value placed upon freedom -- at home as well as abroad -- remains unaltered. Coupled with a revival of the American work ethic, and the rebuilding of an education system second to none, these underlying values can serve as the basis for renewed competitive leadership. But in these changing times, our traditional ideals must be blended with new values: a zeal for winning, and a firm determination to manage our own destiny. Together, the old and the new will form the strong foundation American society will need to successfully meet the challenges that the coming years bring.

APPENDIX I

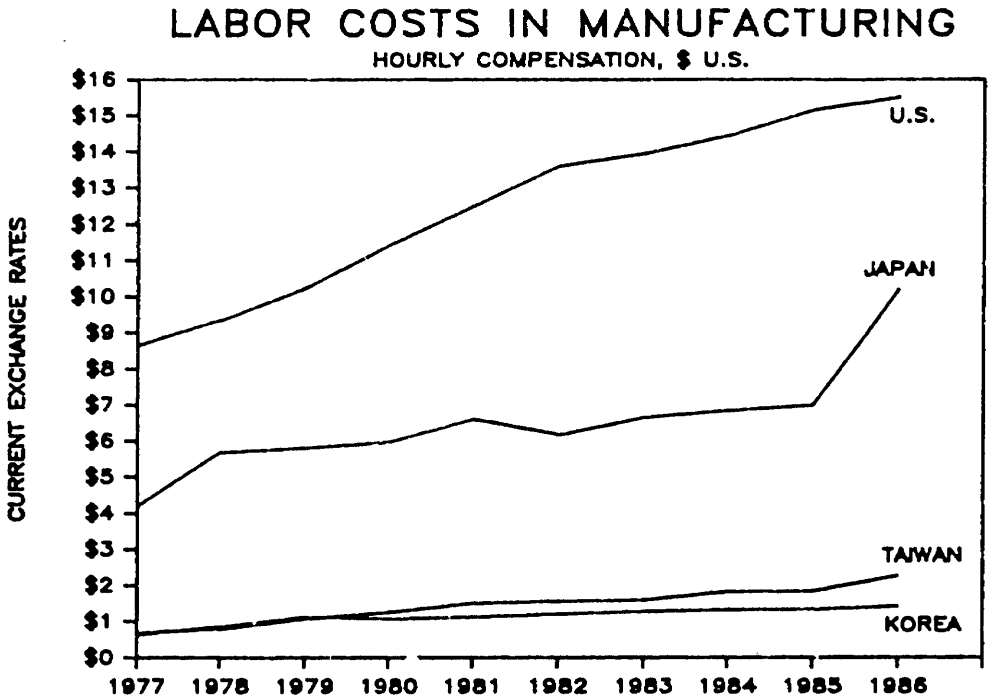
NOTE 1

LONG-TERM ECONOMIC OUTLOOK
1986 - 2016
(1986 Exchange Rates & Prices)

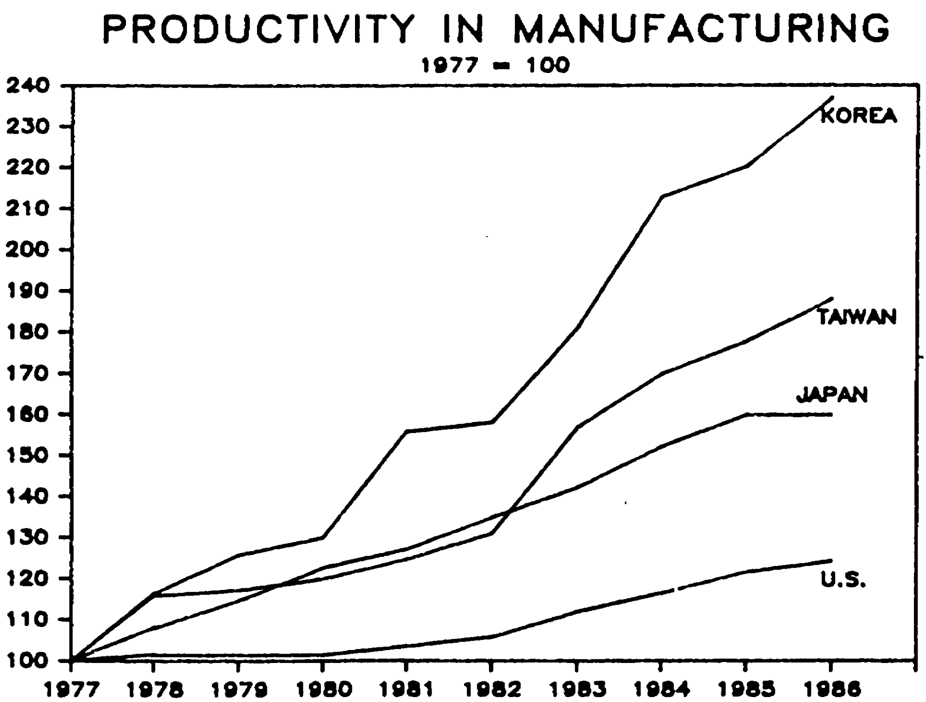
	ANNUAL GROWTH RATES (%)			% OF U.S. GNP	
	LABOR FORCE	OUTPUT/ PERSON	REAL GNP	YEAR 1986	YEAR 2016
U.S.	1.1	1.9	3.0		
WESTERN EUROPE	0.5	2.3	2.8	80	75
ASIA/PACIFIC	1.0	3.1	4.1	71	100

SOURCE: TEXAS INSTRUMENTS INCORPORATED

NOTE 2



SOURCE: U.S. Department of Labor, Bureau of Labor Statistics



SOURCE: U.S. DEPARTMENT OF LABOR, BUREAU OF LABOR STATISTICS

Trade winds blowing across the Pacific

The Atlantic has not gurgled away into the Pacific, but the four Europeans at the seven-country Tokyo summit had better recognise how far the balance of global economic power is shifting in that direction

In 1962, the western Pacific (East Asia and Australasia) accounted for 9% of world ouput, North America for 30% and western Europe for 31%. By 1985, the western Pacific's share had climbed to 13%, North America's dropped to 29% and western Europe's to 25%.

The proportion of world exports from western Pacific countries doubled to 19% between 1962 and 1984. Exports and imports between North America and Asia were worth $192 billion in 1985, compared with $196 billion between North America and its transatlantic suppliers or customers.

This shift in trade occurred without many member governments planning it, or even collecting detailed statistics about what had occurred. The Pacific Basin Economic Council, most of whose members are businessmen from North America, East Asia and Australasia, was set up in 1968. But it was not until 1984 that the first governmental group taking in the countries belonging to the Association of Southeast Asian Nations (ASEAN), America, Australia, Canada, Japan and New Zealand sat down to talk about regional co-operation under the deliberately vague heading of "human resources development".

They will do more such talking in future, for several reasons. First, around two-thirds of their commerce will soon be conducted with each other. Some 62% of the region's exports (including those from North America) went to other countries in the Pacific in 1984, compared with 45% in 1962.

Second, exports are rising as a share of GNP in all these countries. Wharton Econometrics, an American forecasting service, thinks that South Korea and Taiwan will see their exports rise to an enormous 55% of GNP in 1990, from an already large 45% in 1981. Wharton predicts that exports from ASEAN (Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand) will rise from 37% to 39% of gross regional product over the same period.

Third, trade tension has tightened recently because Asian countries gained more than European countries from the high American dollar in 1982-85. Japan's exports to the United States rose 67% to $72 billion in these three years, a rate roughly matched by the rest of East Asia. Despite a slowdown in the growth of East Asia's exports last year, 55% of America's trade deficit was accounted for by a deficit with the region.

Textiles test

According to researchers at the Australian National University in Canberra, East Asia's share of world exports of labour-intensive manufactures should rise from a quarter in 1977-81 to about 37% by 1990. The loudest protectionist noises usually come from those bit by sales of such manufactures, especially producers of textiles and clothing.

A big test of Pacific-trade liberalisation will come during the negotiations to extend the Multifibre Arrangement, which expires at the end of July. America looks like being even more protectionist than the EEC countries about this. It has asked Hongkong, South Korea, Taiwan and China to limit their exports of textiles and garments. Protectionists in the American Congress are threatening to override President Reagan's recent veto of a highly restrictive bill on textile trade, the Jenkins bill. They mutter that they intend to bring Asian producers into more disciplined line.

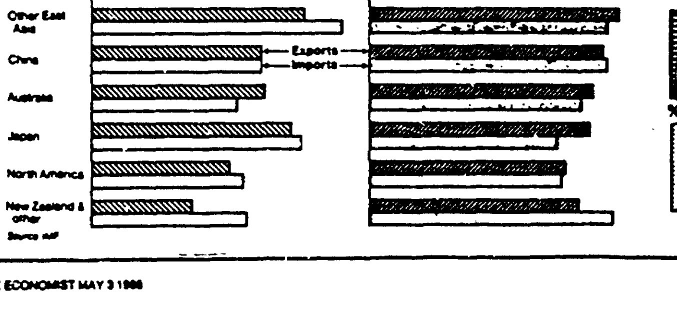
Agricultural products are more heavily protected than manufactured goods. Nominal rates of protection for grains and meat have doubled in Japan since 1965-69. They have risen from 9% to 166% in South Korea over the same period and from 2% to 55% in Taiwan. These levels annoy Australia and the ASEAN countries as well as America; but the United States has itself come in for criticism for passing the Food Security act, which subsidises rice exports to compete with those from Thailand.

A hard American line has helped achieve progress on another irritant: the preservation of intellectual-property rights. Such rights were treated in a cavalier fashion in several Asian developing countries until America's 1984 trade act made benefits under the generalised system of preferences dependent on the protection of copyright by the importer of American works. Taiwan passed a new copyright law in July 1985. A bill on the matter is before parliament in Singapore.

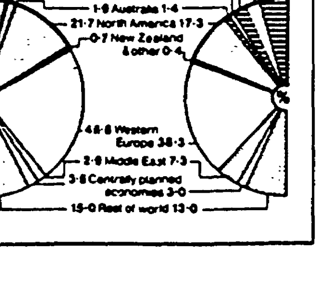
What are the prospects of some eventual equivalent of a free-trading area in the Pacific? America has talked to ASEAN about the possibility of setting up some form of freer-trade arrangement, but Australia says loudly that any liberalising of trade must be done on a non-discriminatory basis. If the Philippines persuaded the Australian government to open the Australian market wider for its dancing shoes, Australia would want to reduce its tariffs on dancing shoes from all countries. It is not keen on preferential trade arrangements.

This view might change. Pacific countries are waiting to see what progress is made at the next round of global negotiations at the GATT, due to start in September. If they come away disappointed, some of them will want to concentrate more on regional trade liberalisation around the Pacific.

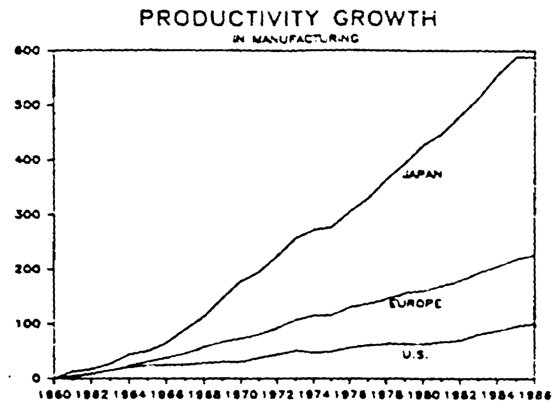
Intra-Pacific trade
% of total trade with other Pacific countries



Share of world exports

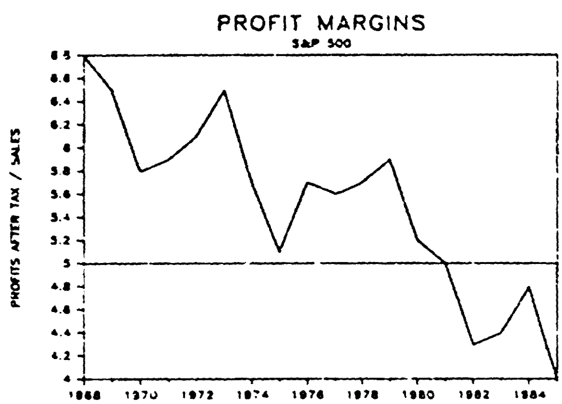


NOTE 4



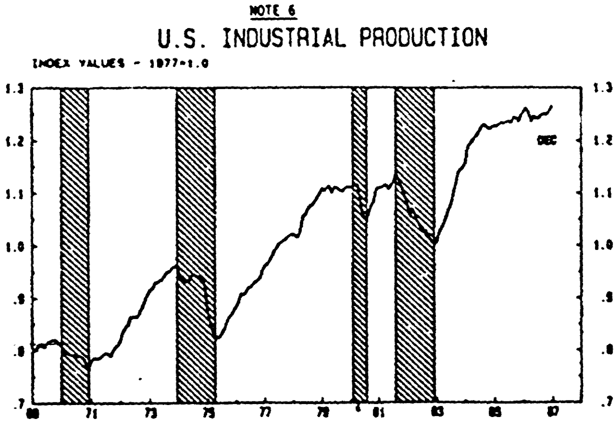
SOURCE: U.S. DEPARTMENT OF LABOR, BUREAU OF LABOR STATISTICS

NOTE 5



SOURCE: STANDARD AND POOR

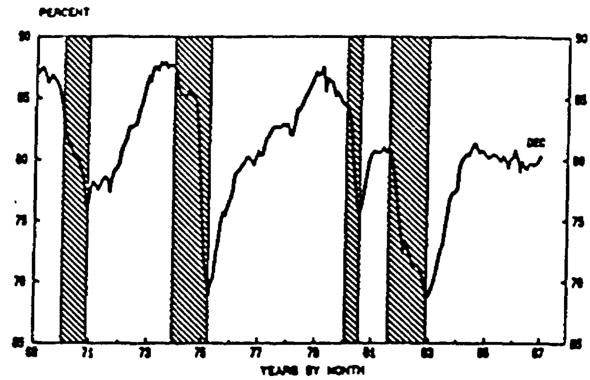
NOTE 6



SOURCE: FEDERAL RESERVE BOARD

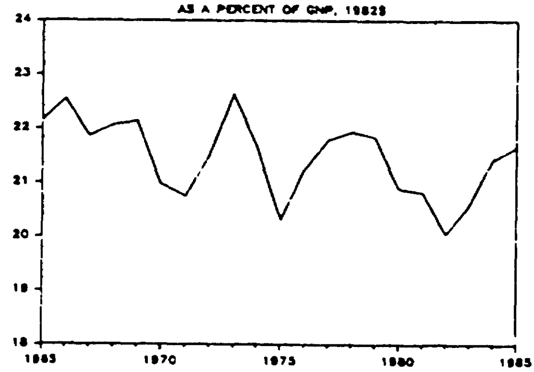
NOTE 7

CAPACITY UTILIZATION
MANUFACTURING



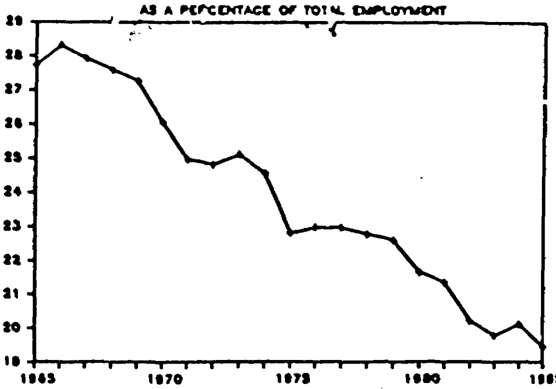
SOURCE: U.S. DEPARTMENT OF COMMERCE, BUREAU OF ECONOMIC ANALYSIS

MANUFACTURING OUTPUT
AS A PERCENT OF GNP, 1982$



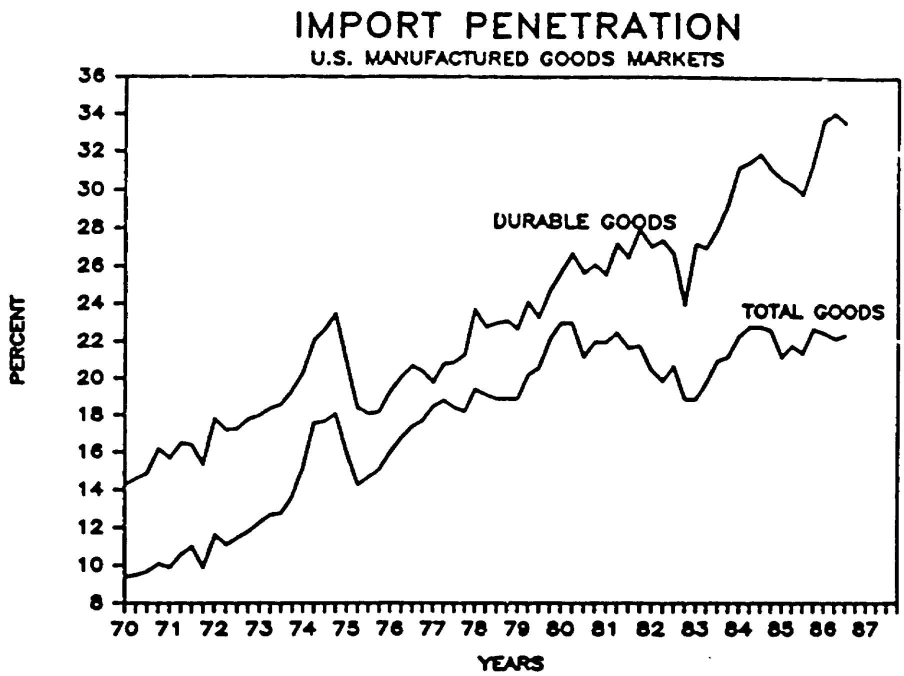
SOURCE: U.S. DEPARTMENT OF COMMERCE, BUREAU OF ECONOMIC ANALYSIS

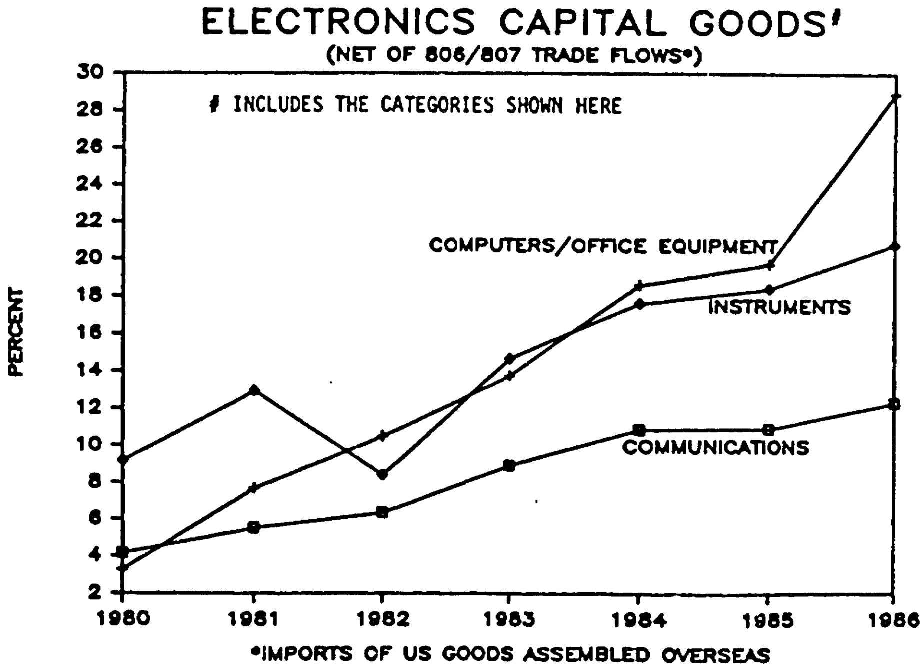
MANUFACTURING EMPLOYMENT
AS A PERCENTAGE OF TOTAL EMPLOYMENT



SOURCE: U.S. DEPARTMENT OF LABOR, BUREAU OF LABOR STATISTICS

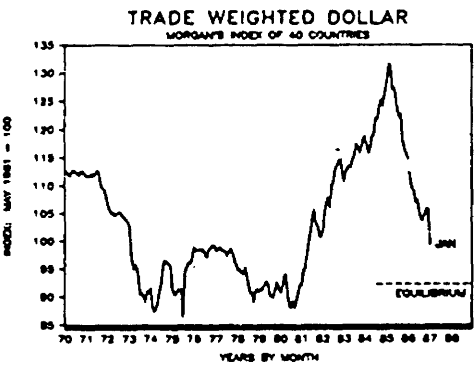
NOTE 8

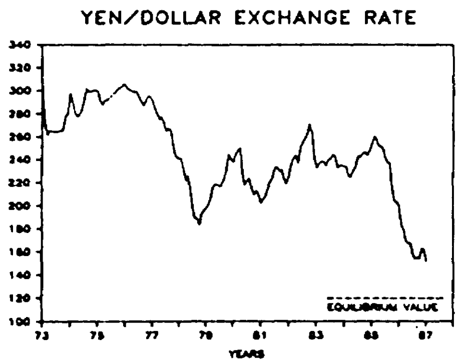


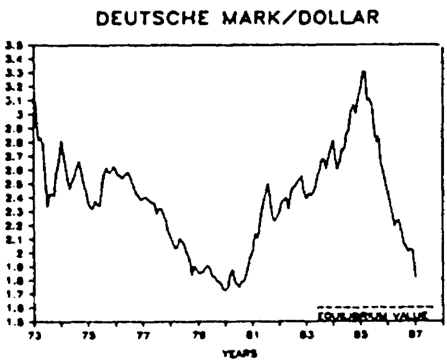


SOURCE: U.S. Department of Commerce, Electronics Industries Association

NOTE 9







According to an analysis by Stephen Marris of the Institute for International Economics (C. Fred Bergsten, Director), the dollar will need to decline to a level corresponding to its 1980 average in order to eliminate the U.S. current account deficit by 1990, a result that corresponds closely to Morgan Guaranty's estimates of the equilibrium value for the U.S. dollar. Dr. Marris estimates that the yen will have to rise to a level of about 120 per dollar, and the DM to a level of 1.57 or less per dollar.

NOTE 10

Another Budget, Another Show

Wall Street Journal
1/6/87

We don't think Washington does proper justice to the federal budget. For instance, the president released his version yesterday. And this morning the country is waking up to read stories describing the budget in a torrent of numbers. But the budget ritual is the heart and soul of Washington, its reason for being. The Beltway should greet the new budget the way revelers greet the new year on Times Square.

They could hoist a dollar sign to the top of the Washington Monument. All the senators, representatives, staffs, bureaucrats, lobbyists, lawyers, the press corps and local merchants could gather around this public dollar sign to revel in another year of federal spending. Happy Fiscal Year!

We make this suggestion only because we don't for a minute believe all the hand-wringing displays and long faces the town's residents put on to greet the new budget. Lawton Chiles and Bill Gray, the new budget chairmen, appeared on "Meet the Press" Sunday looking like pallbearers. Come on, fellas, admit it; spending public money is fun.

The joy of spending is certainly what comes through from a reading of the table of figures accompanying this editorial. When John Kennedy was president, spending ran between 18% and 19% of GNP; now it's running over 23% annually. In fact, the table puts the federal budget in a more accurate perspective than the one the public is continually offered.

Most commentary on the budget basically tells people that it involves something dreadful called "the deficit," that the president "won't get everything he wants for defense," that "there has to be some movement on revenues," and that "domestic spending has been cut to the bone." While the commentators send up these smoke signals, the president and Congress proceed to fight it out for 11 months. We don't believe that the public's understanding of the proper role of the federal government is very well served by this annual exercise.

The accompanying table from OMB offers a snapshot of how the U.S. has chosen to allocate its wealth over the past 25 years. It indicates the choices the country's elected representatives have made for their constituents.

During the 12 years of two of this century's most popular presidents—Dwight Eisenhower and JFK—spending on defense was more than 9% of GNP. If Ronald Reagan and Caspar Weinberger proposed any such thing now, a chanting chorus would call them heartless maniacs.

The key period in the table's history is the mid-1970s. Nondefense spending was 13.4% of GNP in 1974. The following year it suddenly jumped to 16.1%. It is interesting to note that this increase occurred in a year when defense spending was at a relatively low level. Congress never backed off from its unusually high domestic spending level of more than 16% of GNP. As is clear, any increases in defense spending automatically push total spending to unprecedented levels.

Federal Spending as a Percentage of GNP

Fiscal Year	1960	1964	1968	1972	1976	1980	1984	1985	1986
Total Spending	18.2	18.8	20.9	20.1	21.9	22.2	23.1	24.0	23.7
Defense	9.5	8.7	9.6	6.9	5.3	5.0	6.2	6.4	6.9
Non-defense	8.7	10.1	11.3	13.2	16.6	17.1	16.9	17.6	16.8

Yes, the U.S. now has a budget deficit, and it is true that such a deficit can't increase indefinitely without causing economic damage. The key question now facing this country, however, isn't whether its deficit should be $200 billion, $108 billion or zero. The key question is whether the U.S. public accepts or rejects the government's current claim on its wealth.

The public should understand that when Lawton Chiles and Bill Gray say the president has to give on revenues, this has virtually nothing to do with the deficit. They are asking the public to ratify, finally and conclusively, the rising domestic spending levels Congress has legislated over the past 10 years, a process that every Reagan budget has attempted to reverse. They are asking the public to set in place a political philosophy that holds that public spending never declines; it rises steadily, and those rises are paid for one way or another out of government claims on private production.

We are at the same point with the budget that we were when Ronald Reagan arrived in Washington in 1981. Mr. Reagan has never concealed his intentions. He wants Washington's claim on the nation's production to fall, and he has succeeded in reorienting the capital's upward march on domestic outlays. Instead of being allowed to blather on for 11 months about the deficit, Lawton Chiles, Bill Gray and the rest of Congress should be challenged to define explicitly what it is they want.

NOTE 11

The key to competitiveness

JAPAN HAS grown so fast over the past four decades that at present exchange rates its citizens are technically richer than America's and almost twice as wealthy as Britain's.

The fundamental explanation for this near-miraculous growth is to be found in the priority the Japanese place on savings and capital formation. The more a country invests, the greater its potential for future consumption. Japan has grown rich quickly mainly because it has resisted the temptation to dissipate gross national product in immediate consumption.

The contrast with pleasure-loving Anglo-Saxon economies is stark. OECD figures show that between 1981 and 1984 Japan's gross investment was 29 per cent of GNP. Britain's was a meagre 16.7 per cent and the US's was only slightly higher at 17.3 per cent.

Why does Japan invest so much? There are numerous possible explanations, some involving cultural and sociological factors. But American businessmen tend to emphasise one point: capital formation in Japan is high because capital itself is cheap.

Dr George Hatsopoulos, president of Thermo Electron Corporation of Waltham, Massachusetts, has been trying for years to focus attention on relative capital costs. In his latest study* he claims: "Over the past 25 years American manufacturers have been paying three times as much for capital as have their Japanese counterparts."

The result, he says, has been more than twice as much tangible investment per worker in Japan as in the US. He sees America's high cost of capital as the main reason for its steady loss of industrial competitiveness.

International comparisons of labour costs are readily available. The same cannot be said of capital costs, which are complex to calculate because they depend not just on real interest rates but on arcane details of national tax codes, such as depreciation schedules.

However, a recent paper † by two economists at Stanford University, Douglas Bernheim and John Shoven, does attempt an up-to-date comparison of capital costs in the US, Japan, West Germany and the UK.

The cost of capital is the pre-tax return which must be earned on corporate investments in order to offer investors a high enough post-tax return to attract their funds. The overall cost of capital is the average of the cost of debt and equity-financed investments.

Real cost of capital comparisons

	% Japan	% UK	% W. Germany	% US(1)	% US(2)	% US(3)
Cost of capital	2.76	3.56	4.39	5.48	7.16	5.00
Post-tax return to saver	1.80	1.28	0.70	2.24	3.05	5.00
Cost of equity capital	4.22	3.81	6.48	7.03	8.61	5.00
Post-tax equity return	1.71	1.33	0.00	1.89	2.89	5.00
Real interest rate	2.50	3.50	3.50	5.00	5.00	5.00

(1) present regime. (2) with Reagan tax reform. (3) with expenditure tax.
At average interest and inflation rates for the 1980s, using 1985 tax codes. Source: Douglas Bernheim and John Shoven.

The Bernheim/Shoven study certainly confirms that capital is unusually cheap in Japan. In the 1970s, the average real cost of capital in Japan was −1.56 per cent compared with 2.44 per cent in the US. In the 1980s (see table), the cost of capital rose in both countries, but the gap was maintained.

The inefficiency of tax codes is measured by the gap between the cost of capital and the post-tax return received by savers—this is known as the "tax wedge." For equity capital, the US tax wedge is 5.14 percentage points compared with 2.51 points in Japan. This reflects the fact that, while equity costs US companies more than 7 per cent, the individuals who put up the money receive less than 2 per cent net.

Bernheim and Shoven argue that domestic credit market conditions are the single most important determinant of capital costs. Moreover, they maintain that, even in the face of global capital mobility, governments can exert control over domestic real interest rates. Japan has always pursued a mix of fiscal and monetary policies that keeps interest rates low; the US, to its cost, has done the opposite.

Will President Reagan's tax legislation bring down the US cost of capital? No, say Bernheim and Shoven; indeed, on the assumption that it does nothing to bring down US real interest rates, it will have a strongly adverse impact. They calculate that the real cost of capital could rise further to 7.16 per cent and the real cost of equity funds to 8.61 per cent. Moreover, the tax wedge—the indicator of inefficiency—could broaden.

America's equity tax wedge is already high because it is the only country among the four considered which does nothing to alleviate the double taxation of dividends and because it has the most severe tax on realised capital gains on equities. Neither Japan nor West Germany taxes capital gains on securities. US tax reform will make matters worse because it eliminates the investment tax credit and raises further the effective levy on realised capital gains.

Bernheim and Shoven contrast the Reagan reform with the theoretical alternative of a shift to an "expenditure tax," under which all forms of saving would be relieved of taxation. Such a régime would help US industry by equating the cost of, and returns on, all forms of capital with the real interest rate. The tax wedge would be eliminated entirely—ultimate investors would receive in full the pre-tax return generated by a corporate investment.

Their analysis explains why many businessmen and economists believe the Reagan reform is "anti-growth." By raising the cost of capital it may encourage a further shift from investment to consumption and further reduce US industry's competitiveness.

The figures for West Germany and the UK, however, suggest that capital costs are by no means the only determinant of investment. West Germany, after all, has the highest tax wedge, indicating the least efficient tax code, and on average it has faced higher real capital costs than the UK. The discrepancy was more marked before the abolition of British 100 per cent first year capital allowances: in the 1970s, the UK real cost of capital was −1 per cent against almost 5 per cent in West Germany. Yet Britain has always had a weak investment record and West Germany a strong one.

Bernheim is not worried by this apparent contradiction. He points out that West Germany's investment record, while good, is nothing like as strong as Japan's. And he suggests that the UK's investment performance would be even weaker were its real cost of capital to rise to US or West German levels.

The personal sector's willingness to save may be the crucial factor. Japanese individuals, despite negative real returns, have more than financed Japanese domestic investment; indeed the capital outflows are now embarrassing. Attempts to boost investment without stimulating domestic saving often end in tears, as the Americans are discovering. The unavoidable capital inflows merely push up the exchange rate and eliminate the potential gains in competitiveness.

If the Anglo-Saxon economies want to achieve Japanese growth rates, they may have to seek a different balance between consumption and investment. Tax cuts which stimulate consumer spending seem precisely the wrong recipe. What is needed is a mix of monetary and fiscal policies designed to bring down interest rates, along with the kind of tax changes President Reagan shunned: measures to boost saving and penalise consumer borrowing.

**The gap in the cost of capital: causes, effects and remedies.* George Hatsopoulos and Stephen Brooks. Ballinger Publishing Company, Cambridge, Mass.*

†Taxation and the cost of capital: an international comparison. Douglas Bernheim and John Shoven. Paper presented to the American Council for Capital Formation, September 1986.*

FINANCIAL TIMES 10/28/86

NOTE 12

Average Debt/Equity Ratios for Japanese and U.S. SC Firms

	Japan*	U.S.**	Japan/U.S.
1977	1.50	0.22	6.8
1978	1.34	0.21	6.4
1979	1.15	0.24	4.8
1980	1.08	0.28	3.9
1981	0.93	0.22	4.2
1982	0.85	0.22	3.9
1983	0.79	0.20	4.0
1984	0.77	0.23	3.3
1985	0.78	0.35	2.2

* Hitachi, Toshiba, NEC, Matsushita.
** TI, Motorola, National Semiconductor, Intel.

Source: Annual Reports.

NOTE 13

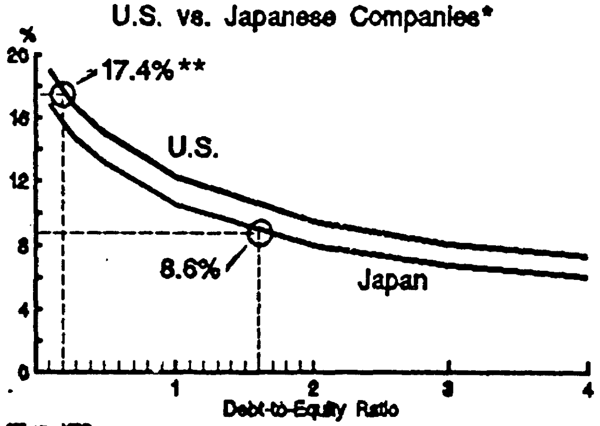
TAX RATES FOR INDIVIDUALS

	JAPAN	U.S.
Effective tax for dividend income:	20.1%	28% Top Rate*
Capital gains tax on sale of stock:	0% if 50 transactions, 200K share/yr.	28% Top Rate
Tax on interest from savings accounts: (multiple accounts common)	0% on account of ¥3,000,000 ($20,000)**	28% Top Rate

*1986 Tax Reform Act.

**Current Law; reforms have been introduced that would impose a 20% withholding tax.

COST OF CAPITAL
U.S. vs. Japanese Companies*



*TI vs. NEC
**See Addendum (next page)

SOURCE: Texas Instruments Incorporated

Addendum to Note 13:

The Reader will have noticed that the estimates of the cost of capital for TI and NEC, prepared by TI (Note 13), differ from those of Bernheim and Shoven (Note 11). There are three important differences in the methodologies used to obtain the estimates in the studies:

1. The Bernheim and Shoven analysis attempts to measure real, or inflation-adjusted, costs of financing. The nominal interest rates used in the TI analysis have been on average more than twice the real interest rates used by Bernheim and Shoven.

2. The cost of equity capital used in the TI analysis has a fundamentally different meaning from that used in Bernheim and Shoven. For TI, the cost of equity is the rate of return required to meet our objectives of profitability and sales growth. Our cost of equity capital will always be higher than the "market" since we could always achieve market returns simply by investing there; we must also consider the risk involved in individual projects versus the risk of a diversified market portfolio. For Bernheim and Shoven, the cost of equity is the historical return required to draw investment funds away from interest bearing securities after considering the tax effects; since real rates of interest have been much lower than nominal rates, Bernheim and Shoven's cost of equity capital (the return necessary to "beat" real interest rates) will also be low.

3. The Bernheim and Shoven analysis considers all industries in the economy, including high, low, and no-growth companies; TI and NEC are in an industry noted for its high potential growth, and therefore higher expected returns.

Despite the differences in magnitudes, however, it is not coincidental that the two studies come to essentially the same conclusion: the Japanese hold a 2-to-1 advantage in the cost of capital. However measured, the tax codes insure that debt is less costly than equity, and the higher debt/equity ratios carried by the Japanese provide an immediate cost advantage. Further, Japanese interest rates (real or nominal) have been considerably less than those in the U.S., magnifying the Japanese tax advantages.

NOTE 14

PROFIT MARGINS*

	JAPAN	U.S.
	TOKYO STOCK EXCHANGE	S&P 500
1968	2.2%	6.8%
1969	2.2	6.5
1970	2.0	5.8
1971	1.6	5.9
1972	1.6	6.1
1973	1.6	6.5
1974	1.1	5.7
1975	0.9	5.1
1976	1.0	5.7
1977	1.2	5.6
1978	1.4	5.7
1979	1.3	5.9
1980	1.6	5.2
1981	1.2	5.0
1982	1.3	4.3
1983	1.5	4.4
1984	1.9	4.8
1985	1.7	4.0
AVG	1.5	5.6

*After-tax profits on sales

SOURCE: Yamaichi Research Institute, Standard & Poor

NOTE 15

Research and Development as Percent of Sales (1983)

U.S. Company	R&D (%)	Japanese Company	R&D (%)	Difference
General Electric	3.4	Hitachi	7.9	+4.5
General Motors	3.5	Toyota	3.9	+0.4
Eastman Kodak	7.3	Fuji Photo Film	6.6	−0.7
DuPont	2.7	Toray Industries	3.1	+0.4
U.S. Steel	0.5	Nippon Steel	1.9	+1.4
Xerox	6.6	Canon	14.6	+8.0
Texas Instruments	6.6	NEC	13.0	+6.4
RCA	2.4	Matsushita Electric Industries	7.2	+4.8
Goodyear	2.6	Bridgestone	4.5	+1.9
Eli Lilly	9.7	Shionogi	9.6	−0.1

Source: Adapted from "R&D Scoreboard 1983," *Business Week*, 9 July 1984, 63–73 and *Nikkei Kaisha Joho*, no. 3 (Nikkei Company Information) (Tokyo: Nihon Keizai Shimbun, 1984).

Top Twenty Japanese and U.S. Companies: Total Annual R&D Expenditures

		Japan	United States
Average Sales per Company, 1983 (¥220:$1.00)		$8.9 billion	$24.7 billion
Average R&D Expenditure per Company, 1983		$446 million	$903 million
R&D Expenditure as Percent of Sales	1983	5.1%	3.7%
	1978	3.1%	2.9%
Annual Increase in R&D Expenditure, 1978–1983			
Current Prices		21.2%	12.9%
Real Prices		17%	4.5%
Annual Increase in Sales 1978–1983			
Current Prices		10.1%	7.9%
Real Prices		5.9%	−0.5%
Approximate Proportion of National R&D Expenditure, 1983		30%	20%

NOTE: Real prices were calculated by deflating current prices by the increase in the consumer price index (CPI) from 1978 to 1983. The consumer price index increased during this period at an annual compound rate of 8.4 percent in the United States and 4.2 percent in Japan. The increase in GNP deflator was 7.5 percent and 2.1 percent respectively. The CPI increase is used in this analysis. Use of the GNP deflator as a measure of inflation would widen the observed differences.
SOURCE: Adapted from "R&D Scoreboard: 1978," *Business Week*, 2 July 1979, "R&D Scoreboard 1983," *Business Week*, 9 July 1984 and *Nikkei Kaisha Joho*, no. 4, *Nikkei Kaisha Joho*, no. 3 (Tokyo: Nihon Keizai Shimbun, 1980 and 1984 respectively).

SOURCE: KAISHA, THE JAPANESE CORPORATION by
James C. Abegglen, et. al.

NOTE 17

Recommendations:

■ **Restructure the tax system.** The tax code should be restructured so that capital can be put to work more effectively, its costs reduced, and productive investments stimulated. Such restructuring should include the following:

(a) Reducing the bias against savings and investment, through greater reliance on taxation of consumption (but keeping progressivity to ensure fairness) and through elimination of the double taxation on corporate profits when received as either dividends or capital gains;

(b) Reducing the variation in effective tax rates on different industries that results from their receiving varying credits and depreciation allowances on different kinds of assets;

(c) Providing inflation adjustments for capital income and capital expense or loss items, similar to existing income tax indexing;

(d) Reducing disincentives to venture and other risk capital investments, for example, by allowing individuals to claim fuller deductions for capital losses; and

(e) Broadening the tax base by including more income items and reducing the number of tax deductions and exclusions, provided this does not increase current disincentives for savings and investment.

Results:

Restructure The Tax System

A. REDUCE THE BIAS AGAINST SAVINGS AND INVESTMENT:

The 1986 Tax Act requires that capital gains be taxed as ordinary income at a 28 percent top rate. The six month holding rule will be abolished.

B. REDUCE VARIATION IN EFFECTIVE TAX RATES ON DIFFERENT INDUSTRIES:

The variation will be reduced as the average effective rates on all industries rise as a result of the elimination of the investment tax credit and a lengthening depreciation schedules. Estimated cost of the Tax Bill for American business is $120 billion over five years.

C. EXTEND INDEXING TO CAPITAL INCOME AND EXPENSE OR LOSS ITEMS:

No action.

D. ENCOURAGE VENTURE AND OTHER RISK CAPITAL INVESTMENT BY ALLOWING INDIVIDUALS TO CLAIM FULLER DEDUCTIONS FOR CAPITAL LOSSES:

The Tax Act further limits the types of income which can be offset by capital losses

E. BROADEN THE BASE TO REDUCE DISTORTIONS AND PREFERENCES IN PERSONAL INCOME TAX, PROVIDED THIS DOES NOT INCREASE CURRENT DISINCENTIVES FOR SAVINGS AND INVESTMENT

The Tax Act achieved some individual income tax base broadening. The Act also reduced one valuable incentive to save and invest by tightening eligibility on IRA deductions and by treating capital gains as regular income.

INSIDE U.S. TRADE — Special Supplement — Dec. 5, 1986

Alternative:

Quantification of the consumption tax rate necessary to offset the re-enactment of the Investment Tax Credit, the exemption of interest income from personal income taxes, the exemption of dividends paid from corporate taxes, and more favorable treatment of capital gains (all amounts except percents in billions of dollars):

		Revenue loss if nontaxable:
Interest received by individuals:	160.0	
Effective tax rate*	12.0%	19.2
Dividends paid by corporations:	121.6	
Effective tax rate*	28.7%	34.9
Capital gains to individuals: (assume maximum tax rate of 20%, rather than 28%)	80	6.4
Investment tax credit (1983 tax code):		25.0
Total tax loss from repeal:		85.5
Personal consumption less food and medical:	1841.1	
Consumption tax rate needed to offset revenue loss:		4.6%

*Source: Data Resources, Inc.

Source: Texas Instruments, Inc.

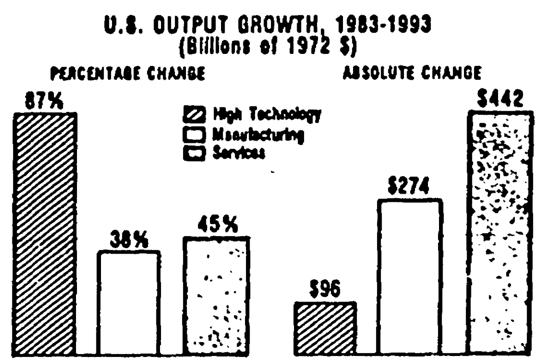
SOURCE: The Report of the President's Commission on Industrial Competitiveness.

NOTE 18

Compound Annual Growth Rates of Selected Industries, 1973-86

SIC	Top 10	Rate	SIC	Last 10	Rate
3674	Semiconductor devices	32 3	3511	Turbine generator sets	-8 6
3573	Computing equipment	18 0	2386	Leather/-lined clothing	-6.6
3832	Optical devices/lenses	16 5	3914	Silver & plated ware	-6 1
2831	Biological products	11 3	3333	Primary zinc	-5 7
3693	X-ray apparatus & tubes	11 3	3144	Women's footwear	-5 4
3678	Electronic connectors	10 7	3636	Sewing machines	-5 3
2833	Medicinals & botanicals	9 4	2121	Cigars	-5 2
3825	Elec-measuring devices	8 9	2661	Bldg paper/board mills	-5 1
2795	Lithographic services	8 4	2517	Wood TV, radio cabinets	-5 1
3829	Instruments, nec	8 4	3542	Metal-forming machines	-4 4

SOURCE: U.S. DEPARTMENT OF COMMERCE, U.S. INDUSTRIAL OUTLOOK 1986



SOURCE: Developed from Data Resources, Inc. For reference see Business Week, March 28, 1983, pp. 84-90.

High tech High technology is often touted as the source of new employment opportunities to help replace jobs lost in declining "smokestack" industries. While faster-growing than the average for all sectors, and particularly the manufacturing sector, high tech industries are projected to account for only a small proportion of new jobs through 1995.

The Bureau's definition of a high technology industry rests on the level of research and development expenditures, the ratio of scientific and technical personnel to total employment, and product sophistication. BLS developed three definitions of high tech, ranging from very broad to very narrow, in its first look at this subject.[5] New employment projections for industries meeting the tests for the intermediate definition are shown in table 6.

Employment in these high technology industries accounted for 6.1 percent of all wage and salary jobs in 1972, 6.4 percent in 1984, and is projected to represent 7.0 percent by 1995. About 1.7 million, or almost 11 percent, of the 15.9 million total new jobs added between 1984 and 1995 will be in those high technology industries. As can be seen in table 6, 40 percent of the new high tech jobs will be in computer and data processing services.

Under the very broadest definition, which includes some mining, communications, trade, and professional services industries as well as additional manufacturing sectors, high tech will account for 14.6 percent of all jobs in 1995, an increase of 3.2 million from 1984's level. Under the narrowest definition, which is limited to drugs, computers, communications equipment, electronic components, and aircraft and guided missiles, the high tech share in 1995 will be 3.2 percent, reflecting the addition of 0.7 million new jobs.

Table 6. Wage and salary employment in high technology industries,[1] 1972–95

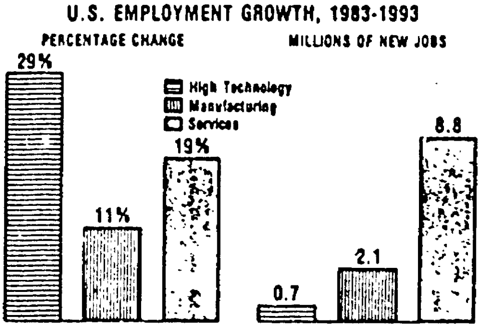
[In thousands]

SIC[2]	Industry	1972	1984	Projected, 1995
	Total nonfarm wage and salary	73 675	94 461	110 092
	High technology	4 469	6 024	7 730
	Percent of total	6 1	6 4	7 0
281	Industrial inorganic chemicals	141	143	152
282	Plastic materials and synthetics	229	177	181
283	Drugs	153	206	243
284	Cleaners and toilet preparations	122	145	160
285	Paints and allied products	69	62	57
286	Industrial organic chemicals	143	164	165
287	Agricultural chemicals	56	61	61
289	Miscellaneous chemical products	90	92	90
291	Petroleum refining	151	151	142
348	Ordnance and accessories	82	76	86
351	Engines and turbines	115	115	124
355	Special industry machinery	177	168	197
357	Office computing and accounting machines	260	526	756
361	Electric transmission equipment	128	116	131
362	Electrical industrial apparatus	209	206	241
365	Radio and television receiving equipment	140	91	85
366	Communication equipment	458	617	787
367	Electronic components and accessories	355	673	846
369	Miscellaneous electrical machinery and supplies	132	156	186
372	Aircraft and parts	495	596	670
376	Guided missiles and space vehicles	93	155	198
381	Engineering and laboratory instruments	65	80	92
382	Measuring and controlling instruments	160	250	310
383	Optical instruments and lenses	18	35	34
384	Medical and dental instruments and supplies	91	172	234
386	Photographic equipment and supplies	117	124	135
737	Computer and data processing services	107	474	1,149
7391	Research and development laboratories	111	193	240

[1] See text footnote 6

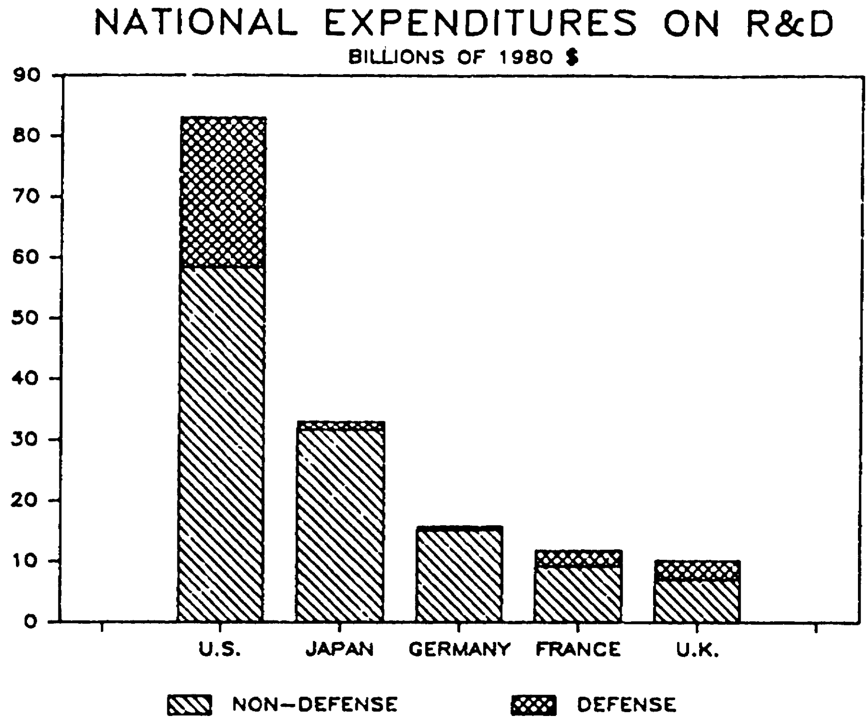
[2] Standard industrial classification as defined by the U S Office of Management and Budget through 1972

U.S. EMPLOYMENT GROWTH, 1983-1993

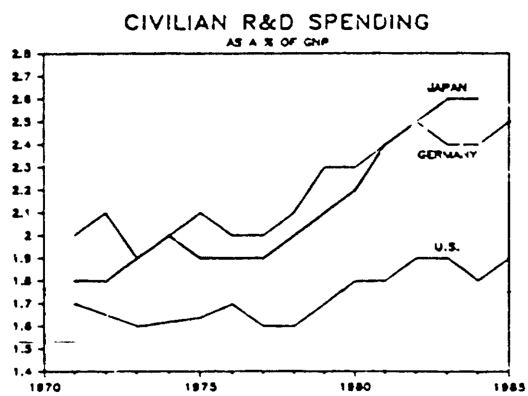


SOURCE: Developed from Data Resources, Inc. For reference see Business Week, March 28, 1983, pp. 84-90.

NOTE 20



The United States spent more on research and development than Japan, West Germany and France combined in 1984 -- 83 billior constant 1980 dollars for the United States, compared with 60.6 billion for the other three countries. However, The U.S. ratio of nondefense research and development as a percent of GNP is well below that of Japan and West Germany. In the 1980's the U.S. ratio has leveled off at about 1.9 percent. West Germany's nondefense ratio increased to 2.5 percent in 1985 and Japan's ratio was 2.6 percent.

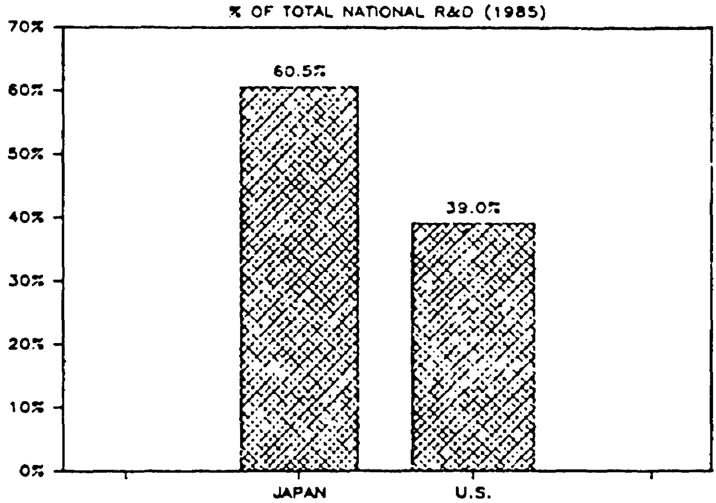


SOURCE: National Science Foundation

NOTE 21

R&D IN MANUFACTURING

% OF TOTAL NATIONAL R&D (1985)



SOURCE: NATIONAL SCIENCE FOUNDATION, JAPANESE MANAGEMENT AND COORDINATION AGENCY

NOTE 22

ELAPSED TIME INVENTION TO PRODUCTION
1953-1973

	YEARS
U.S.A.	7.4
FRANCE	7.3
UNITED KINGDOM	6.7
W. GERMANY	5.6
JAPAN	3.5

SOURCE: NATIONAL SCIENCE FOUNDATION, 1976

NOTE 23

IMPORTANCE OF INTEGRATED MANUFACTURING

Most strategic planning focuses on financial numbers, basic research, and product design based on market demand. Only rarely does it focus on manufacturing. This has produced a mentality that considers manufacturing as process separate from design and distribution, and automation strategies have concentrated on improving isolated pieces of that process. For the future, U.S. companies must broaden this perspective and look on manufacturing as an integrated process.

By "integrated" I mean two things. First, manufacturing must be an equal partner with R&D and marketing and become an integral part of a total business strategy. A complete business strategy encompasses a broad spectrum of activities:

- Supporting basic R&D;
- Understanding customer needs, which is the essence of marketing;
- Defining products that meet those needs;
- Getting the right materials;
- Having state-of-the-art manufacturing equipment;
- Making a quality product;
- Delivering the product and providing excellent customer service; and, perhaps most important,
- Managing the interrelationships among the people involved in this entire process.

Second, the manufacturing process itself must be treated in its totality. The most efficient use of resources requires looking at the process an an integrated system, and then investing in the resources necessary to optimize that system toward the fundamental goals of quality and productivity.

SOURCE: "Sharpening America's Competitive Edge: The Role of Technology in Mnaufacturing", by Mark Shepherd, Jr., an address at the International Industrial Engineering Conference in Dallas, Texas on May 13, 1986

NOTE 24.

PCIC Recommendation: R&D tax credits should be made permanent.

Present law: The Tax Reform Act of 1986 did not make the R&D tax credit permanent, but only extended the credit for three years, through the end of 1988.

Arguments for making the credit permanent:

From a staff study prepared for the Joint Economic Committee, July, 1985: "The long term nature of research and development is at odds with a temporary credit. A permanent credit would give a greater stimulus to R&D funding and would, therefore, be more cost effective."

From an American Enterprise Institute report on the R&D tax credit: "Typically, R&D manpower increases in each year of a successful project, accelerating until commercialization and completion. Because of the accelerating nature of research costs in a project and the higher costs in the later stage of development, clearly, the permanent credit is a much more effective incentive."

Prospects for a permanent extension:

According to a report in the National Journal, the R&D tax credit has a wide circle of congressional admirers. Both the House and the Senate approved the extension of the credit in the Tax Reform Act; the Senate had originally voted a four year extension, which was reduced to three in conference.

Senate Bill 58, introduced on January 6, 1987 and sponsored by Senators Danforth, Baucus, Wallop, Boren, Durenberger, Mitchell, Riegle, et.al. would make the R&D credit permanent, and also increase the rate to 25%.

NOTE 25.

PCIC Recommendation: Make the R&D tax credit more meaningful. Consider applying the credit to total, rather than incremental, R&D spending.

Present law: The Tax Reform Act of 1986 reduced the credit on incremental R&D expenditures from 25 to 20 percent.

Arguments for increasing the credit:

In its present form, due to the fact that incremental spending today raises the spending base in subsequent years, a 25% nominal tax credit results in an effective after-tax cost reduction of only 19 cents for each incremental dollar of R&D spending, under the most optimistic scenario. More pessimistic estimates (by Eisner, et.al.) put the effective rate much lower, at perhaps a few cents on the dollar.

Returning the R&D credit to 25 percent would result in an immediate loss of revenue to the Treasury of only about $300 million -- an amount that would be returned many times over in future revenues from higher economic growth -- a miniscule .3% of projected federal government spending next year.

According to a study by Data Resources, Inc., sponsored by TI in early 1984, the introduction of a 25% tax credit on total R&D expenditures would boost R&D spending by 24% per year and raise productivity gains by 2.9% per year in the second decade after enactment. Although the enactment would cause an immediate increase of $13 billion in the budget deficit, the increased flow of revenue from a faster growing economy would eventually offset the increased cost of the credit. By the year 2003, the 19th year after enactment, the cumulative improvement to the deficit would be about $300 billion.

Prospects for making the credit more meaningful:

A survey by the National Science Board found that over seventy percent of the U.S. public believes that the federal government should provide larger tax incentives to increase industrial R&D.

Senate Bill 58, introduced on January 6, 1987 and sponsored by Senators Danforth, Baucus, Wallop, Boren, Durenberger, Mitchell, Riegle, et.al. would make the R&D credit permanent, and also increase the rate to 25%.

NOTE 26.

PCIC Recommendation: Broaden the definition of eligible expenses to include the development and implementation of innovative manufacturing processes, machinery, and facilities.

Present law: The definition of qualified R&D has been further limited by the Tax Reform Act. "Research is eligible for the credit only if the research is undertaken for the purpose of discovering information (a) technological in nature, and also (b) the application of which is intended to be useful in the development of a new or improved business component. In addition, such research is eligible only if substantially all of the activities constitute elements of a process of experimentation for a functional purpose."

Source: Conference Committee report on the Tax Reform Act of 1986

Arguments for broadening the definition of R&D:

The development of volume production equipment and processes necessary to bring a prototype to full-scale production may require more complex technology than the product development itself. The phase of manufacturing following the development of a prototype is currently ineligible for R&D tax credits.

A comparison of the present law with Japan's R&D credit (also incremental, also 20%) reveals that the Japanese credit is considerably more inclusive. Many of the indirect costs associated with R&D are included in the Japanese credit but excluded in the U.S. version. These indirect costs may account for as much as 25% of total R&D spending.

Augmenting the FASB-2 definition of R&D expenses to include the development and implementation of manufacturing processes would provide a standard for which accounting and audit systems are well established.

Prospects for a broader definition of R&D:

Senator Danforth (R. Mo.) has introduced legislation in the past that would include R&D conducted for production equipment and processes. However, the overall scope of the legislation is more restrictive than current law.

The "McNuggets story" (in which McDonald's allegedly took R&D credits for the development of Chicken McNuggets, later denied by the company) has heightened legislative sensitivity to claims that the R&D credit is being misapplied. Both the House and Senate versions of the Tax Reform Act tightened the eligibility of existing credits.

NOTE 27.

PCIC Recommendation: Make permanent the moratorium on Treasury Regulation 1.861-8 requiring allocation of domestic R&D expenditures to foreign source income.

Present law: The moratorium (expired August, 1986) is replaced with temporary rules adopting, with some liberalization, proposed Treasury regulations extending from August 1, 1986 to August 1, 1987. The new rules automatically allocate 50% of domestic R&D to U.S. sources, with the balance apportioned according to the ratio of foreign to total income. Attempts were made to repeal 1.861-8 or at least extend the moratorium. Instead, Congress is instructed to study the issue for two years and adopt permanent rules on R&D expense allocation.

Arguments for making the moratorium permanent:

Regulation 1.861-8 artificially allocates a portion of R&D expenses to foreign source income. Since the reduction in foreign source income may reduce the amount of foreign taxes eligible for credit against United States taxes, U.S.-based multinationals may have to pay double taxes on a part of their overseas activities. To counter this effect, R&D activities may be moved overseas and the cost of such activities taken as deductions against overseas income.

Thus, we may be indirectly subsidizing foreign R&D efforts, using foreign personnel and exporting patentable and proprietary information.

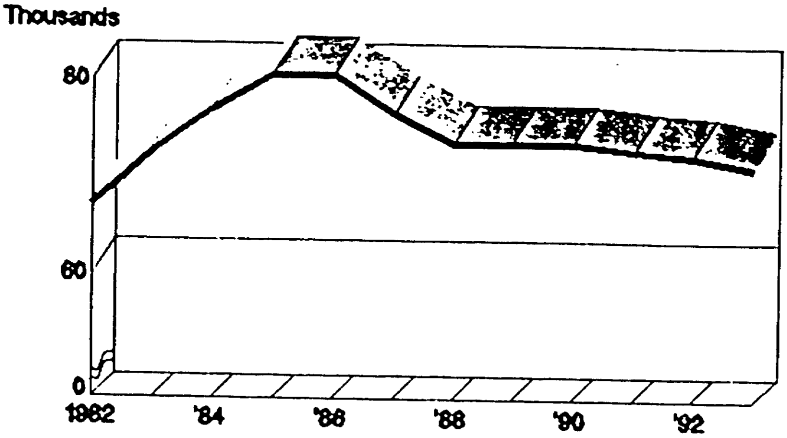
Prospects for a moratorium:

Three Senate Finance Committee members, Danforth (R-Mo), Wallop (R-Wyo), and Baucus (D-Mont), are planning to push legislation early this year to insure that R&D expenses incurred by U.S. multinationals will be allocated fully to domestic sources.

Treasury Department officials and some industry groups believe that the "50% formula" (that is, the current law) can be the basis of a permanent statutory rule governing allocation of R&D credits.

NOTE 28

ENGINEERING BACHELOR'S DEGREES GRANTED IN THE U.S., 1982–1993



Source: Engineering Manpower Commission & TI

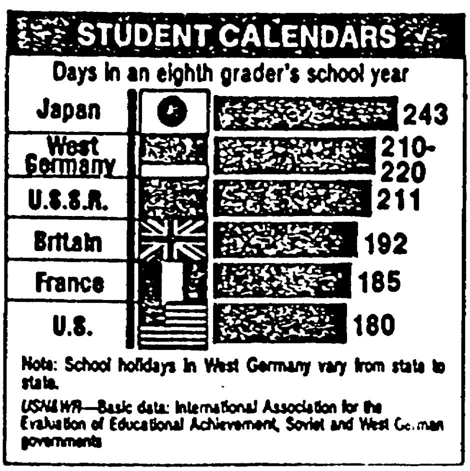
Although recent figures on U.S. engineering graduates show some improvement, these increases in the number of bachelor's degrees are deceptive. Projections of engineering graduates suggest that we have reached a peak. We face a downturn over the next decade, partly because of a drop in the available college-age population and partly because the capacity of our engineering schools is approaching its limit. Some engineering schools are actually reducing their enrollments, and a shortage of engineering Ph.D.'s is reducing the supply of qualified instructors.

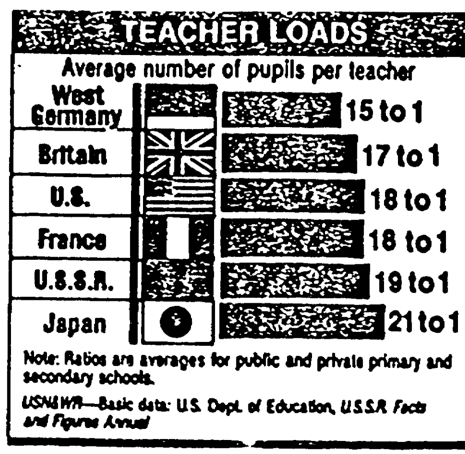
NOTE 29

America may soon face a critical shortage of skilled teachers. But Japan won't. There are 5 applicants for each opening in its teaching ranks. Polls show that Japanese teachers hold as much social status as engineers. In Japan, there's no such thing as merit pay for teachers, but they still earn 2.4 times the nation's per capita income. By contrast, American teachers make only 1.7 times the U.S. figure. Nowhere is respect for Japan's teachers higher than in the classroom. From the start, they make proper group behavior a No. 1 priority. First graders learn in the first week of school to stand and bow when the teacher enters.

Most American teachers are trained in schools of education, where they learn not what to teach but how to teach. Such training is common for grade-school teachers in Japan and Europe, but few high-school teachers abroad major in education. Nearly all are specialists in the subjects they teach.

NOTE 30





U.S. NEWS & WORLD REPORT JANUARY 19, 1987

THE WALL STREET JOURNAL APRIL 2, 1985

NOTE 31

U.S. Export Curbs Contribute to the Trade Deficit

By MURRAY L. WEIDENBAUM

Imports are surging into the U.S. so rapidly that our trade deficit is approaching the size of the much vilified $180 billion federal budget deficit. Hasty but dramatic cures are being peddled in Congress, including a 20% surcharge on imports.

The arguments against this negative approach are well-known. Much of the surcharge will be paid by U.S. consumers and, in the aggregate, it will increase domestic prices. Perhaps more important is the likelihood of kicking off a nasty trade war with key foreign-policy allies.

Fortunately, there is an alternative response to the trade problem. Free-trade proponents need not be advocates of a "do nothing" policy. A more constructive approach to reducing the trade deficit can proceed from a little-known fact: The U.S. has erected many barriers to its own exports. These are self-inflicted wounds that are easily treated.

For example, the Trans-Alaskan Pipeline Authorization Act prohibits the export of oil from North Slope fields. Under free-trade conditions, Alaska would be Japan's least-cost supplier of energy. Further, permitting Alaskan oil to be shipped to Japan would help ensure vital supplies of energy to an important ally that is now vulnerable to Middle East oil interruptions.

Another law bars the export of timber from federal lands (the federal government is the largest owner of timber land in the U.S.). Once again, the major potential customer is Japan. Removing these two restrictions could reduce the U.S. trade deficit by as much as $20 billion.

The most significant statutory barrier to U.S. exports is the Export Administration Act, which places export controls on goods and technology to protect national security. In practice, the statute is used to control a great variety of products with little relationship to military needs.

A clear example is the use of the law in the 1974 embargo of soybean exports—hardly an item of strategic importance. The purpose was to contain a short-term increase in domestic grain prices. The main effect, however, was to induce overseas customers to seek other suppliers. Japan proceeded to invest heavily in Brazil in order to develop a reliable alternative. More recently, the act was used to deny grain to the Soviet Union, and in a futile effort to stop the construction of the natural gas pipeline from Western Europe to the U.S.S.R. In both of these instances, foreign suppliers replaced U.S. agriculture and industry.

We read so much about the difficulty U.S. firms experience in selling telecommunications equipment to Japan. Those problems are very real. But in other growing Asian markets, such as Hong Kong and Singapore, serious barriers arise from our own export licensing system. One U.S. consulate has stated that, because of licensing delays, U.S. companies have become "unreliable, last-resort suppliers" of telecommunications equipment.

The Export Administration Act is an example of regulatory overkill. No one wants to provide military hardware to the Russians. But just because a part is used on some weapons system does not justify preventing its export—not when the part is also standard commercial equipment. U.S. companies should be free to export without license products that are available from other countries. Otherwise, current federal policy only winds up punishing U.S. exporters, and not the U.S.S.R.

Another burden to U.S. trade is the Foreign Corrupt Practices Act, which requires strict record-keeping standards to guard against bribery of foreign officials. It is difficult to discuss that law without being criticized for ethical callousness. However, this statute shares the cavalier attitude toward the burdens imposed on U.S. business of so many other regulations.

Harold Williams, a former chairman of the Securities and Exchange Commission, which administers the act, has stated, "The anxieties created by the Foreign Corrupt Practices Act—among men and women of utmost good faith—have been, in my experience, without equal."

The language of the act is so sweeping and ambiguous that American firms turn down foreign business when they merely suspect that they could be charged for actions technically classifiable as bribery. In a survey of 250 American companies, the General Accounting Office found that 30% of the respondents engaged in foreign trade had lost business as a result of the Foreign Corrupt Practices Act.

Realism also requires us to acknowledge the impediments to imports that we have erected. Although the U.S. invariably plays the aggrieved party in international trade negotiations (usually for a valid reason), we tend to forget our own protectionist lapses. Foreigners do not hesitate to remind us that our hands are not clean.

"Buy American" statutes give preference to our own producers in government procurement. U.S. flag vessels must be used to ship at least one-half of the commodities furnished under the foreign aid program. Import quotas are imposed on products ranging from steel to beef. High tariffs on such items as motorcycles serve a similar purpose.

Our restrictions on imports also lead to retaliation against our exports. Take the example of China, a nation with which we have a favorable trade balance. When U.S. imports of textile products from China were limited, that country quickly retaliated by reducing its imports of U.S. farm and chemical products.

More indirectly, protection of some industries reduces the competitiveness of others. For example, quotas on steel imports result in higher prices for American consumers. Who is the largest customer of U.S.-made steel? The domestic auto industry. Competition from abroad is the single most important factor encouraging competitive behavior at home.

Of course, the high value of the dollar also presents difficulties for American companies. A sharply lower budget deficit is likely to help much more than an import surcharge, and not generate the adverse side effects. A special tax on foreign commerce is a poor response to the reality of the U.S. trade deficit. But American business is competing in world markets with one hand tied behind its back. Eliminating most U.S. barriers to its own exports would untie the other hand—and result in a more even contest.

Mr. Weidenbaum, a former chairman of President Reagan's Council of Economic Advisers, is director of the Center for the Study of American Business at Washington University in St. Louis.

NOTE 32

Although GATT's 90 member countries account for 80 percent of world trade, only some 20 percent of total trade is conducted under GATT rules, according to one study. Another report by a U.S. presidential commission claims that GATT rules now apply to less than 5 percent of world trade compared to 20 percent in 1950. These trends explain the spreading frustration at the GATT's inability to stem the rising tide of protectionism and resolve trade disputes. a declaration adopted at the ministerial meeting of the GATT in November 1982 begins with the warning that "The multilateral trading system ... is seriously endangered". Many observers believe that unless something is done, GATT will become increasingly irrelevant.

SOURCE: Japan Economic Institute Report, April 11, 1986

Even the best GATT codes will not achieve their purpose without enforcement. Until GATT has its own enforcement powers, each member nation should incorporate the GATT codes into its own trade laws, which can be then enforced through national courts. The alternative to a strong ATT is to risk the further spread of individual bilateral agreements, making international trade all but unworkable.

SOURCE: "The New GATT Round of International Trade Negotiations", by Mark Shepherd, Jr., an address to the U.S.-German Industrialists' Meeting on October 26, 1986, Frankfurt, Germany.

NOTE 33

Maekawa Commission Report Unveiled

A panel of advisers to Prime Minister Yasuhiro Nakasone formally submitted a report April 7 calling for changes in Japan's export oriented industrial structure to reduce the nation's current account surplus. The Advisory Group on Economic Structural Adjustment for International Harmony, headed by former Bank of Japan governor Haruo Maekawa, produced an 11 page report following five months of debate.

The report outlines principles for transforming Japan's economy to growth based on domestic demand. To stimulate consumer spending, it proposes income tax cuts and shorter working hours. The panel maintains that market access for foreign goods, including agricultural commodities, should be improved. It also calls for efforts to stabilize exchange rates and to pursue financial liberalization to make the role of Japan's financial markets commensurate with the nation's importance in the world economy.

The commission further advised that Japan should help resolve global problems, such as the debt burden of developing countries. As for fiscal policy, the report calls for a continuation of fiscal reform aimed at ending dependence on deficit covering bonds, but it adds that fiscal policy should be "flexible," which is being interpreted as support for more government construction bonds to fund public works projects.

Reactions to the report have been mixed. While U.S. policymakers have praised it, a strong undercurrent of skepticism is evident in other countries. Domestic comment has been mostly critical or, at best, reserved. Potential candidates for Mr. Nakasone's position immediately assailed the report as being too forward and explicit — a direct contrast to the reaction abroad.

Opposition party politicians, as well as members of the prime minister's own party, expressed fears that Mr. Nakasone had somehow committed the nation to the reform program without consulting them.

Japan's business community has reservations as well. Several industrialists claimed that the changes would lead to a reduction of Japan's international competitiveness, increased unemployment and greater tax burdens.

They agreed, however, that more money should be invested in social infrastructure and that it may be time for Japan to begin enjoying more of the fruits of its labor.

Japan Economic Survey/May 1986 3

NOTE 34

Estimates of the proportion of the U.S. trade deficit with Japan attributable to Japanese trade barriers range from a low of 15% ($9 billion) (Bergsten and Cline, The U.S. - Japan Problem) to a high of 25% ($15 billion) (U.S. Department of Commerce). Even if all Japanese barriers were dismantled, the bilateral deficit in 1986 would still have been 45-50 billion dollars.

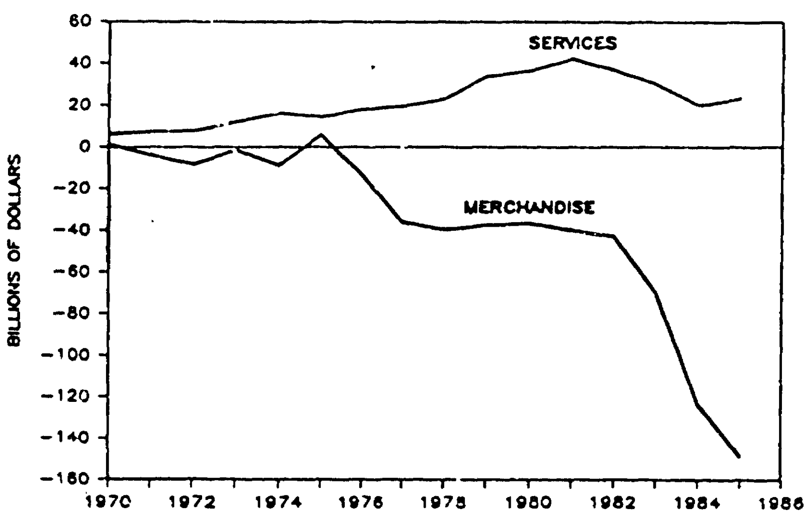
NOTE 35

Services - The architects of the international trading system largely ignored the service sector, which includes such industries as banking, trouism, data processing, construction and engineering. Advances in telecommunications have facilitated the rapid transmission of data over long distance, enabling service industries to operate on an international scale. Although the liberalization of goods markets and capital markets has opened new international opportunities for the service sector, its exports often face import barriers more restictive than those applied to manufacturers. Moreover, constraints on foreign investment make it difficult for firms to establish the permanent facilities they need to compete successfully in local markets. Despite the lack of a coherent system of principles and procedures, global trade in services is estimated at $400-$500 billion annually, approximately 20 percent of world trade in goods and services.

SOURCES: THE JAPAN ECONOMIC INSTITUTE REPORT, APRIL 11, 1986

NOTE 36

U.S. TRADE BALANCE



SOURCE: U.S. Department of Commerce, Bureau of the Census

NOTE 37

Trade in services is not a new issue, but it is an increasingly important one for the international trading system. Over the past decade, global services exports have grown in lockstep with merchangidse exports, and now total about $400 billion per year. There are three main reasons for this growth.

First, there has been a dramatic increase in the "tradeability" of services. New technologies have revolutionized the number and types of services available internationally. The communications revolution has reshpaed industrial organization and labor markets, opening up new opportunities for internationally-provided services. New information technologies permit more decentralized bases of production in more integrated multi-sector firms. These trends encourage specialization and economies of scale in the production and trade of services.

Second, the growing interlinkages between services and goods production have greatly expanded service trade. Services now are an integral part of the production and marketing of many manufactured goods. Services provide essential inputs (from engineering design to data processing), drive the production process (e.g. robotics; automated assembly lines) and facilitate the marketing of goods (from financing and insuring the transaction to providing after-sales maintenance). Moreover, as products become more sophisticated, less materials and more technical services are needed. In the 1960s, services (e.g. software) accounted for only about 20 percent of the cost of a computer system; today the hardware costs are 20 per cent and software, engineering, and consulting services absorb the rest.

Third, the liberalization of trade and capital markets has contributed to a growing demand for services in increasingly interdependent markets. Global services exports grew by 11.25 per cent annually over the period 1968-83, about the same rate as merchandise exports. Foreign direct investment (FDI) also expanded substantially, from average annual flows worldwide during 1965-69 of $6.6 billion to $49.4 billion during 1980-83. These investments allowed multinationals to centralize purchases and provided a growing market for traded services.

SOURCE: "Trade in Services and Developing Countries" by Jeffrey J. Schott and Jacqueline Mazza, In The Journal of World Trade Law, January 1986.

THE NEW YORK TIMES, SUNDAY, SEPTEMBER 14, 1986

NOTE 38

Services — the Star of U.S. Trade

But competition and restraints from abroad are growing and the sector may soon become a battleground.

By LESLIE WAYNE

ONCE America's export trade meant shiploads of cars from Detroit, bolts of cloth from Southern textile mills and farm machines from the Middle West. But, as America's traditional merchandise has been overtaken in the world marketplace, trade has emerged with a new look. Service exports — fees generated in Europe by Wall Street bankers and in the Middle East by American construction firms, royalties from overseas sales of Madonna records and McDonald's hamburgers, and rentals for Rambo films — have become the new symbol of America's grandeur abroad. They are the bright spot in an otherwise bleak trade picture.

Increasingly, America's competitive advantage appears to lie with its brainpower and perhaps its star power, rather than its industrial muscle.

Increasingly, America's competitive advantage appears to lie with its brainpower and perhaps its star power, rather than its industrial muscle.

But the selling of services is a subtle form of trade, difficult to count because it cannot always be seen as it crosses national borders. "Services move silently," said Walter F. O'Connor, international vice chairman of Peat Marwick Mitchell & Company. No one actually sees a phone call between a banker in New York and a client in London. Accounting for these "invisible services" is difficult and many believe that that the actual numbers may be higher than statistics indicate.

According to government figures, however, services represent about one third of the nation's $800 billion-plus flow of exports and imports. Last year merchandise trade plunged ever-deeper into red ink, with a record $125 billion deficit. The service sector helped redress the balance: Services rolled up a surplus of $21 billion, with $144 billion in exports outweighing $122.3 billion of imports.

"The service sector is important because it is in our favor and it helps offset the very serious deterioration in our merchandise account," said Lacy Hunt, chief economist at Carroll McEntee McGinley, Inc. "And this is one area where it will be hard for foreign competition to supersede us." Added Eric J. Kruger, director of economic research at the Conference Board: "America is constantly innovating and trying to become more efficient. This is a very competitive, very creative environment that is hard to beat."

Still, no one expects services to bail America out of its trade problems. "Services do dampen the trade deficit," said Richard B. Self, deputy associate United States trade representative. "But services alone will not make enough of a dent on the trade deficit to make it healthy." Yet, American innovation and technology give the service sector a strong competitive edge — at least for now.

But the game is getting tougher. Protectionist barriers have been rising in many countries. And services are expected to become a battleground in the new round of international trade talks that open tomorrow in Punta del Este, Uruguay. Some new players, particularly Japan and South Korea, are beginning to encroach on America's overseas service strongholds of banking and engineering.

In addition, the huge American budget deficit further hurts the nation's service trade balance. Foreigners have snapped up Treasury securities issued to finance the deficit, and the billions in interest payments that flow to foreign holders of Treasury securities worsen the service trade balance and offset the dollars generated from the sale of actual services overseas. As a result, the service trade surplus has been shrinking at an alarming rate — it was $41 billion dollars as recently as 1981 and $36 billion in 1982. (In the last 18 months or so, the trend has leveled off and edged slightly upward, as profits being remitted to American parent companies by their foreign subsidiaries, which count as exports, were translated into weakening dollars.)

The service trade is a key issue to American representatives at the General Agreement on Trade and Tariffs talks that open tomorrow. Trade ministers from some 92 nations will begin a series of talks, expected to extend over several years, aimed at dismantling trade barriers and crafting new rules for international commerce. The Reagan Administration has set as a primary goal the adoption of rules governing service trade — something that GATT discussions have not addressed before.

THIS, however, will not be an easy task. Some developing countries, Brazil and India for instance, are opposed to anything that might threaten their own developing service industries. And some American manufacturers and unions fear that the trade-off for getting other countries to open their service markets will be more foreign goods coming into the United States. For the American service industry, however, removing the restrictions abroad is a top priority.

"As America continues to transform into a service economy, it is important to try to arrest the growth of trade barriers to services," said Harry L. Freeman, an executive vice president of American Express, which has far-flung international operations including worldwide distribution of its credit cards, international banking and brokerage. In 1974 American Express and a small group of other service companies founded the Coalition of Service Industries, a Washington-based trade group that lobbied hard for inclusion of services in the GATT talks. "The fact that our services surplus is decreasing," said Margaret Sims, executive director of the group, " is symptomatic of the lack of cohesive attention to this."

Already, subtle restrictions that fall under the heading of "non-tariff" trade barriers limit sales of American services abroad (See box). Unlike goods, services cannot be taxed or stopped at a country's border, so countries impose limits on foreign operations to protect local producers.

One company that has felt the sting is Warner Communications, which produces movies, VCR's and records from such stars as Frank Sinatra, Linda Ronstadt and Madonna. "Overseas sales are a vital part of our business," said Jay Berman, vice president of public affairs at Warner. "The Japanese can manufacture a machine to display our works. But no one can create the audio and video programming like us."

But overseas, Warner constantly finds itself hampered by market access limits — restrictions on where an American movie can be shown, for how many hours and who can distribute the film. It is also hurt when other nations ignore copyright violations. "In some areas of the Middle East, our movies are available on VCR's before they are even shown in the theater," Mr. Berman added.

Executives of Bechtel, the giant construction firm, complain that overseas competition is made more difficult by "mixed credits," which are basically a form of subsidized financing offered in some countries. French or Japanese construction firms, for instance, can request help from their governments in arranging low-cost financing for a construction project — say, a power plant in Indonesia. The final package is usually much cheaper than what Bechtel and other American companies can arrange.

"It makes it hard for American firms to compete," said Peggy A. Houlihan, manager of legislative programs for Bechtel. In 1975, American companies won the bidding on nearly 50 percent of all overseas construction projects, according to Bechtel. This share dropped to 30 percent by 1982. No more recent figures are available, but Bechtel is certain that the American share has sunk even further.

If non-tariff barriers are one obstacle to increasing the service trade balance, the growing American budget deficit is another. When the Government makes payments to a Japanese holder of Treasury bills, the interest payments count as an American import and hurt the domestic service trade balance. And as the deficit grows, more Treasury securities are sold abroad, and the flow of interest payments swells. Last year interest payments to foreign holders of Treasury securities grew by nearly $2 billion, to reach about $21 billion for the entire year. The 1986 payments are expected to be even bigger.

So far, more interest payments have been coming in — mainly from American loans to foreigners — than have been sent out to foreign holders of Treasury securities. But some warn that if the budget deficit continues to widen, the entire service trade balance could very easily move from positive to negative, just as the merchandise trade balance already has.

"This is not a good trend," said Howard Rosen, a research associate at the Institute for International Economics in Washington. "We run the risk of running a deficit in both service and goods trade and that is why the GATT negotiators are going in very heavily to negotiate for services. They know they have to build up our service exports to pay for our manufacturing trade deficit. We've been building a stronger service trade and in recent years, we've seen it deteriorate largely because of the interest payments on the Federal debt."

Another troublesome trend is that America is collecting less interest from loans abroad, which are counted as exports. At the end of 1985, the United States had taken in $10 billion less from overseas lending than in the previous year. Mainly this reflects the impact of the third world debt crisis. Third world countries are getting fewer new loans from American banks. In addition, many of these countries have slowed interest payments on existing loans as part of their debt-rescheduling programs.

The vagaries of travel also play into the service trade balance. Traditionally, Americans traveling abroad have far outnumbered overseas tourists coming to the States. The dollars Americans spend abroad are counted in the American import column, hurting the service trade balance. Fears of terrorism have somewhat dampened the number of American tourists abroad this year, but they still outnumber visitors here. At the same time, terrorism fears have also caused many travelers of all nationalities to shun American airlines in favor of foreign carriers, further hurting the American service trade balance.

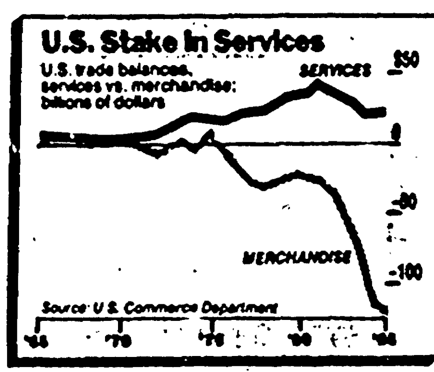
DESPITE these concerns, many say America's service trade is in better shape than the numbers show. Experts say there is drastic undercounting of service exports, largely because of the difficulty of coming up with an accurate tally when there are no specific goods that can be counted as they leave the country. The service sector is "our number one trade priority and we know little about it," said Mr. Rosen. "It's hard to keep track of and we have very poor data."

While acknowledging that foreigners have made inroads into many lines of service business, experts also say that services are broad and flexible enough to provide new business opportunities for those who continue to innovate — an American strength. Some low-level services — keypunch operations, for instance — may have been permanently lost to countries in the Far East and the Caribbean with much lower labor costs than the United States. Yet no one sees America being overtaken in services, particularly in the more sophisticated and technical areas, as it has been in so many goods areas.

"Our foreign competitors are growing fast," said F. William Hawley, director of international government relations for Citibank. "But, I don't think we will be wiped out like car makers. The impact of competition on manufacturing is different than on services. In the financial sector, for instance, there are so many new markets and new services that can be provided that it creates a certain resilience — assuming also that American regulators keep their rules flexible, too."

The sale of services is, of course, closely entwined with the sale of goods overseas, and each promotes the other. When I.B.M. sells a computer abroad, it creates opportunities for American software and other computer services. The sophisticated trade expertise available from Chase or Citibank makes it easier for American exporters to sell their wares.

"You have an interaction between goods and services," said Bernard Ascher, director of the service industry affairs office of the United States Trade Representative. Added Claude Barfield, director of science and technology policy studies at the American Enterprise Institute: "It's not an either-or situation. Goods and services complement each other. But one of the GATT trade-offs may be that to get concessions in services, we will have to give concessions in manufacturing." ■



NOTE 39

RECOMMENDATIONS:

Strengthen Protection of Intellectual Property Rights

The strengthening of intellectual property rights at home and abroad should be a priority item on the Nation's policy agenda and, together with industry, the Federal Government should commit itself to a detailed strategy of actions to achieve this goal. Among the specific actions suggested are the following:

- Deter product counterfeiting by making the trafficking in counterfeit trademarks with intent to deceive or defraud a criminal offense. Support international efforts to implement an anticounterfeiting code.
- Amend the Freedom of Information Act to protect the rights of private firms to maintain the confidentiality of information of potential commercial applications that they are required to disclose to the Government.
- Support legislation that would restore patent life lost during the Government approval process.
- Streamline patent laws and procedures so that patent laws continue to be a major mechanism to encourage R&D and the commercial development of new technology.

SOURCE: "The Report of the President's Commission on Industrial Competitiveness."

And the results:

Strengthen Protection of Intellectual Property Rights

A. DETER COUNTERFEITING BY MAKING THE TRAFFICKING ON COUNTERFEIT TRADEMARKS A CRIMINAL OFFENSE:
There are considerable support in the 99th Congress for legislation which would provide the same protection for process patents as currently exists for patents on products. The Administration strongly supports this and other legislation related to protection of U.S. intellectual property. The protection of U.S. owned intellectual property was incorporated into the Trade and Tariff Act of 1984 as a condition for trade preferences under the generalized system of preference. The President has taken actions against certain abusing countries through the Office of the U.S. Trade Representative and has insisted that intellectual property issues be on the agenda of the up-coming new round of GATT multilateral trade talks.

B. AMEND THE FREEDOM OF INFORMATION ACT TO PROTECT THE RIGHTS OF PRIVATE FIRMS TO MAINTAIN THE CONFIDENTIALITY OF INFORMATION OF POTENTIAL COMMERCIAL APPLICATIONS:
No change.

C. SUPPORT LEGISLATION THAT WOULD RESTORE PATENT LIFE LOST DURING THE GOVERNMENT APPROVAL PROCESS:
Partially restored for pharmaceuticals in 1984.

D. STREAMLINE PATENT LAWS AND PROCEDURES TO ENCOURAGE R&D:
The only comprehensive data resource for compiling and tracking trends in patented technologies worldwide, the tiny Office of Policy Analysis within the U.S. Patent Office, was eliminated in 1985. Automation of the Patent Office is proceeding slowly.

INSIDE U.S. TRADE -- Special Supplement -- December 5, 1986

NOTE 40

A TRADE PACT FOR CHIPS

Helping an Industry Fight the Good Fight

By DAVID B. YOFFIE

THE United States and Japan recently signed an agreement that will radically restructure their semiconductor trade. Neither protectionist nor overtly mercantilist, the agreement promotes American interests while helping world trade.

The deal guarantees the United States "more than 20 percent" of Japan's semiconductor market by 1991, compared with only 8.2 percent today. In addition, the Japanese Ministry of International Trade and Industry will monitor prices and clamp down on dumping of selected semiconductors exported to America and third markets. In exchange, we have suspended retaliation against alleged unfair Japanese trade practices in semiconductors.

Such an agreement will be attacked from every angle: for raising prices to American consumers; for violating President Reagan's free market principles; for setting a dangerous precedent in other sectors.

Yet all of these dogmatic free trade arguments miss the point. When an industry is dynamic, export-oriented, and systematically attacked by foreign competitors, the Government should intervene. And if there was ever such an industry, it is semiconductors.

Unlike steel, apparel and most declining industries, few semiconductor trade problems have been of their own making. Since the American invention of the transistor in 1947, American companies have been technological leaders. The semiconductor industry spends more on R&D (10.7 percent of sales in 1985) than any other American industry (average 3.1 percent). And unlike most industries, chip makers have never myopically focused on the domestic market. Through 1984, American chips outsold Japan's by 5 to 1 in Europe.

Despite the dynamism and export

David B. Yoffie, associate professor at the Harvard Business School, is author of "Power and Protectionism."

tors never deeply penetrated Japan. Since 1973, our share of Japan's market has hovered mysteriously around 10 percent. Moreover, some Japanese companies began an unabashed attack to dominate their American competitors. A Hitachi memorandum, which ordered its sales force to quote 10 percent below United States companies, no matter what the cost, was one of the clearest examples of predatory pricing in recent trade history.

The semiconductor agreement attacks these problems head-on. By specifying a target market share in Japan for American chips, it necessitates some Japanese liberalization. Virtually every year since 1981, Japan has trumpeted a series of market opening measures. Nonetheless, Japan's total imports were lower in 1985 than they were five years ago. Without a precise market share goal, nothing is likely to be accomplished. Similarly, the monitoring system for checking prices should prevent a repetition of the Hitachi debacle. And since the United States only suspended its retaliation against Japan, the Government has maintained its leverage in case of future violations.

IN ADDITION to helping our semiconductor industry, this agreement should help world trade. With the American trade deficit running at an annual rate of $170 billion, Congress wants action. Last September, the President promised a new trade policy and he will finally support that promise. The semiconductor agreement undoubtedly helped the Administration avert a Congressional override of the textile quota bill — a bill that would have destroyed the recently renewed Multi-Fiber Arrangement and any chances for a new GATT round. Furthermore, the agreement is not truly protectionist. Its most important feature is opening the Japanese market, not closing the American. By not including in the agreement producers from Taiwan, Korea and Europe, American manufacturers will continue to have incentives to be innovative and efficient.

The agreement may also promote world trade by helping Japan open its domestic market. Bureaucratic and popular resistance to purchasing more foreign goods has frustrated some Japanese political leaders as much as American industry. Prime Minister Yasuhiro Nakasone knows that Japan must reduce its trade surplus, projected to reach $60 billion in 1986. But he also realizes the futility of pleading on Japanese television for every citizen to buy $100 of foreign goods.

Japan alters its trade policy only when foreign nations apply pressure. The bureaucracy and many Japanese companies have long resisted domestic political efforts to create a new trading strategy. However, when foreign governments credibly threaten Japan, as the United States did in autos in 1981, Japanese politicians can use the foreign threat to force changes. Thus, this agreement may not only assist Mr. Reagan with Congress, it may help Mr. Nakasone fight protectionist leanings in Japan.

The agreement is not perfect. It excludes 1 megabit D-RAMS, which are the future in semiconductor trade. And it will also require constant American vigilance. A similar export monitoring arrangement for steel in the late 1970's fell apart when it was circumvented by many American importers and foreign exporters.

No matter what the problems in implementation, this agreement sets the right precedent for a new American trade policy. It tells Japan that we will assist important industries in international trade; it tells Congress that there are alternatives to protectionism, and it tells American business that if you are dynamic, export-oriented and unfairly attacked, the Government can be an ally. ■

New York Times
8/10/86

NOTE 41

Annual indices of relative unit labor costs are developed by dividing the indices of compensation by the comparable indices of productivity. For example, Korea's 1986 ULC, which is 37.9% that of the U.S., is derived as follows:

	U.S.	KOREA
• Levels in 1986		
Absolute Productivity*	124.3	30.3
Hourly Compensation	$15.53	$1.44
• Translation to Relative Indices		
Absolute Productivity	100	24.4
Hourly Compensation	100	9.2
• Translation to Relative Unit Labor Costs		
ULC = Comp./Prod.	100	37.9
• Addendum		
1986 Average Exchange Rate		880

Exchange rate needed to bring ULCs into equality $\frac{37.9}{100} \times 880.0 = 334$

RELATIVE UNIT LABOR COST IN MANUFACTURING

YEAR	U.S.	KOREA	TAIWAN
1975	100.0	47.8	53.7
1976	100.0	53.2	52.8
1977	100.0	57.1	54.4
1978	100.0	62.7	52.5
1979	100.0	70.1	59.7
1980	100.0	57.6	65.8
1981	100.0	47.4	70.7
1982	100.0	46.9	65.3
1983	100.0	44.7	57.7
1984	100.0	39.8	61.4
1985	100.0	38.6	58.5
1986	100.0	37.9	68.1
1986 XRATES		880	36
EQUILIBRIUM RATES		334	24

*Annual indices of absolute productivity in manufacturing are developed from data published by the United Nations on value-added in manufacturing, and from 1973 base levels of output per labor hour calculated by the National Institute of Economic and Social Research, London, England, in local currency and translated into U.S. dollars at 1973 exchange rates for all years. Each country's base level of absolute productivity is extended with indices published by the U.S. Bureau of Labor Statistics.

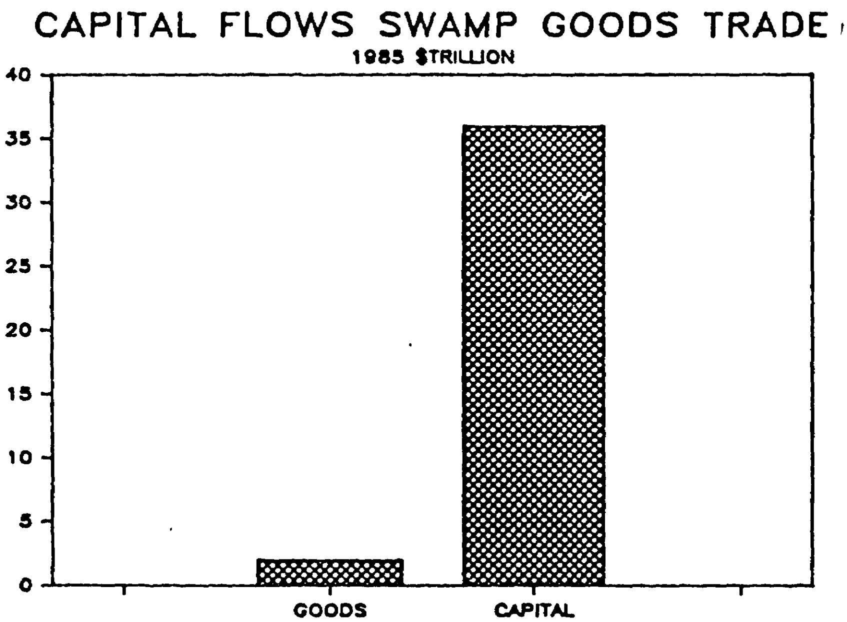
SOURCE: National Institute of Economic and Social Research, London, England; United Nations *Yearbook*, various issues; U.S. Bureau of Labor Statistics; Texas Instruments

NOTE 42

World trade in goods is larger, much larger, than it has ever been before. And so is the "invisible trade", the trade in service. Together, the two amount to around $2.5 trillion to $3 trillion a year. But the London Eurodollar market, in which the world's financial institutions borrow from and lend to each other, turns over $300 billion each working day, or $75 trillion a year, a volume at least 25 times that of world trade.

In addition, there are the foreign exchange transactions in the world's main money centers, in which one currency is traded against another. These run around $150 billion a day, or about $35 trillion a year -- 18 times the worldwide trade in goods.

SOURCE: "The Changed World Economy" in Foreign Affairs, by Peter F. Drucker.



NOTE 43

TARGET ZONES FOR EXCHANGE RATES

Although the idea of target zones is not a new one (the 1974 IMF guidelines for floating encouraged but did not require countries to establish target zones in consultation with the Fund), the instability and persistent misalignments associated with the current exchange rate regime have prompted a resurgence of interest in the concept. John Williamson of the Institute for International Economics (C. Fred Bergsten, Director) is generally given credit for the modern synthesis of target zones. Others who support the general concept of managed exchange rates include Ronald McKinnon of Stanford, Richard Cooper of Harvard, Paul Krugman of MIT, and Robert Mundell of Columbia. Arguments in favor of target zones include:

1. Exchange rates based on economic fundamentals rather than speculative capital flows;

2. Domestic economic policies attuned explicitly to considerations of international competitiveness;

3. Prevention of "beggar thy neighbor" exchange rate wars;

4. A stable financial environment more conducive to long-term investment.

Arguments <u>against</u> target zones include:

1. The difficulty of establishing and agreeing upon "fundamental equilibrium exchange rates";

2. The requirement of coordinating policies may limit a country's ability to address domestic economic concerns;

3. A recent Brookings study suggests that the benefits to the U.S. from coordinating policies may actually be rather small.

APPENDIX II

The Do's and Don'ts of Trade Policy

What follows is a summary of the most important actions that government (and academia) should/should not take in order to increase the competitiveness of the U.S. economy. While some of these recommendations may appear to be politically unacceptable, we need to bite the bullet and take immediate action in order to prevent an irreversible deterioration.

Desirable Actions

1. Make the U.S. more attractive as a location for manufacturing.

   o Lower the cost of capital.

   - Put downward pressure on interest rates by reducing the budget deficit.
   - Increase capital formation by resurrecting the investment tax credit, by repealing the double taxation of dividends and by lowering the tax on capital gains.
   - Encourage savings -- and offset revenues lost through reform -- with a tax on consumption.

   o Increase incentives for private R&D.

   - Make the R&D tax credit permanent.
   - Restore the 25% R&D tax rate that was in effect prior to the Tax Reform of 1986.
   - Broaden the definition of R&D to include the expenses involved in developing and implementing innovative manufacturing processes, machinery and facilities.
   - Make permanent the moratorium against the required allocation of domestic R&D expenses to foreign-source income.

2. Make trade a two-way street.

   o Keep the dollar competitive by reducing the budget deficit.
   o Remove long-term distortions in exchange rates by implementing a new system of target zones.
   o Bring pressure to bear on our trading partners in order to provide reciprocal trade opportunities.
   o Provide GATT with the power of enforcement.
   - Protect intellectual property rights.
   - Facilitate trade in services.

3. Raise U.S. educational standards.

   o In primary and secondary schools:
      - Encourage state and local school boards to adopt more challenging standard requirements.
      - Provide the necessary financial incentives to attract and retain capable teachers.
      - Lengthen the school year.

   o In colleges and universities:
      - Increase the capacity of our technical education system to alleviate the shortage of engineers.
      - Emphasize co-op programs that allow a student to earn the money required to pursue an engineering degree while providing the student with valuable industry experience.
      - Develop curricula that support lifelong education for self-renewal.

Undesirable Actions

1. Do not focus exclusively on trade solutions as a quick fix to the nation's trade problem. The roots of the problem reach deeper than trade.

2. Do not embrace protectionism in the form of tariffs, quotas and surcharges as a viable solution to the trade deficit. Make a trade bill not a trade war.

3. Do not attempt to balance the budget by raising taxes. The cure would be worse than the disease.

4. Do not be misled into thinking that industrial policy, however defined, will boost U.S. competitiveness. The futility of industrial policy in restoring productivity could only be compared to the futility of price controls in containing inflation.

5. Do not relegate the education issue to the backburner. Education matters just as much as defense. The quality of our workers will be of paramount importance in our national effort to regain a leadership position.

The CHAIRMAN. Thank you very much, Mr. Shepherd.

We will follow the early bird rule here insofar as the asking of questions goes. And after the chairman it is Senators Rockefeller, Riegle, Daschle, Heinz, and Danforth.

Gentlemen, I think you have some very extensive and intensive recommendations.

One of the points you made was the question of getting down the budget deficit. There is no question about that having to be one of the primary goals. And one of the problems is going to be the perception of what is done. Now you have seen the President's budget that has been sent to us, saying it achieved $108 billion. In all candor, in my experience in business, if I had used those kinds of accounting practices and assumptions to develop the balance sheet of my business I would have been hauled before the SEC. But that isn't the way in a political life, I guess.

And the Congressional Budget Office—which is nonpartisan—says that the president's budget is approximately $30 billion short of achieving that objective of $108 billion. My guess is that when we get through with the budget in the Congress, if we use the same kind of accounting assumptions and procedures that the Administration did, we will probably say we reached the $108 billion. But my hunch is that we will be about $30 billion short too.

Now that is the bad news. But I think the good news is that, overall, we will probably cut the deficit from last year by some $25 to $35 billion. And that is a very significant cut and I hope there is some attention to that as we try to see that we continue to get our securities bought by foreigners and try to help us bridge this kind of a deficit and turn it around.

One of the other points you made—let's see, you made this one, Mr. Robinson—in that trade legislation doesn't resolve it all. And that is certainly true. We cannot write any bill that is all of a sudden going to turn this thing around 180 degrees and say that we have wiped out the trade deficit. Any trade legislation we pass is going to operate at the margins; is going to try to help; going to try to make a contribution; going to try to tighten up procedures, accelerate procedures; have some adjudication of the problem while we still have that industry in being. That is what we will be striving for.

One of the things I note here, Mr. Robinson, is the President's Commission on Industrial Competitiveness rejects the idea that trade in services can offset the declining U.S. position in manufacturing, because they argue that the volume of services exported are small compared to the volume of goods exported, and that many services produced in this country, like medical care, education, and the like, cannot be exported.

Now you are in a business of services. We hear the arguments about low pay scales, low productivity. They are often prevalent in the service industry. Do you think we can expect the service sector to fill that void for manufacturing?

Mr. ROBINSON. Well I don't think it can fill the void for manufacturing, and I don't think the two should be looked at as a trade off. We do, of course, actively support the inclusion of services under GATT, and in any bilateral negotiation, as well as the utilization of 301 to open markets such as with Korea, in insurance.

The perception that the service industry is a low paying industry of hot dog stands, is totally erroneous. It really is driven by a lot of the technology that comes out of Texas Instruments and other companies in areas such as financial services, and engineering, and those parts of the broadly defined service sector.

We believe that with sensible trade legislation, the United States will continue to have the opportunity to continue to grow a strong service sector. That is where a good 90 percent of the job growth has come from.

The CHAIRMAN. Mr. Shepherd, if they weren't running a fast clock on me, I would ask you to answer to that one. But let me get to the other point.

What can we do in the way of trade adjustment assistance? We really had a failure there. What can we do with trying to get on the right track in taking care of displaced workers, the idea of treating them and training them in new skills where they can lead productive lives? What better way can we do it than we have? We just haven't been very successful at it. And we found, frankly, a lot of waste of taxpayers' money in many of those programs.

Mr. SHEPHERD. Well there are, I think, two pieces. Industry itself needs to generate ongoing training programs of all sorts, which we do in our company, all the way from people on the production lines, through upgrading the education of Ph.D's.

From the government's standpoint, it seems to me the most effective thing you could do is to put the mechanisms on a much faster track so that you can very rapidly reach the conclusion that there have been displaced workers. And once that is done, remove as much as the bureaucracy as you can so you can get on with it.

There is a basic problem in trying to retrain many folks though. It is difficult to convince persons who have been in a 20 or 25 dollar an hour job that they lose that they should spend effort retraining for a ten dollar an hour job. That is a major social problem and it takes time.

The CHAIRMAN. I see my time has expired.

Senator Rockefeller, would you proceed, please?

Senator ROCKEFELLER. Thank you, Mr. Chairman.

Mr. Shepherd, if I could just follow up on the Chairman's line of questioning. It is often a matter of codewords when we talk about, let's say, an auto worker in this country who may be making around $20 and an auto worker in Korea who may be making a fraction of that. The immediate assumption is that in order to compete our standard of living has to decline. I don't buy that. On the one hand, our standard of living has been declining anyway since 1973 in real terms. We have had many difficult negotiations on both a union and non-union basis in this country. There have been concessions on both sides with respect to no increases in wages, decreases in wages, flexibility of work rules, management concessions of a variety of sorts, information sharing, board membership, etc.

But then you look at Germany, Belgium, Sweden, and others where their wage levels are comparable to ours. Their standards of living are comparable, and in some cases, higher than our own.

They have clearly made an adjustment of some sort with their workers. You mentioned basic skills several times, and you talked a great deal about the ethic of education and parental involvement—a broad series of things that have to be done. If you agree, as I assume you do, that there is a great deal of skill training that is going to have to take place, doesn't this mean not just getting people from a ninth grade education to a twelth grade education but a whole new range of technological training and upgrading that will have to take place three, four, five times in a young person's lifetime?

Are you hopeful about this? You mentioned that we have got to get rid of bureaucracy, and maybe that will help. We certainly have to get rid of old ways of doing things. But right now, training affects maybe 5 percent of the displaced workers who have been out of work for three years or more.

What are you really talking about in your own thinking of a substantial way—and I would think this would take at least 5 to 10 years to be really effective—of taking the American worker, whether that worker is 20 years old or 55 years old; whether he has been a steelworker, a coal miner, or whatever for many years and years, and doing something with that person? Or do you think it is too late? Do we have to do it as the Germans and the Japanese, to some extent, do, that is, they start out as apprentices and there is then a technological work base before you ever go to work? Now, is that too late for a 50 year old? Is that in time for a 20 year old? What are you talking about when you talk about upgrading basic skills in this country?

Mr. SHEPHERD. I think the biggest problem we have is not with the displaced worker. I do not mean that I am not very sympathetic to that problem. But the biggest problem we have is in our basic education. When we have young people who have a high school diploma who cannot write a check, cannot really read and understand instructions, we have a terrible problem. Now that is a problem that will take at least a generation to fix, and it is a problem that we all have to participate in solving because it has to do with motivation of people. And we elaborate on this in the full text of this testimony.

It is an issue of how we pay, and how we respect school teachers, and what we demand of school teachers. And I think, most importantly, it involves whether you have parent involvement or do not have parent involvement. We will never solve educational problems without parent involvement. And that becomes an enormous problem with the so-called single parent family.

Not only are displaced workers a concern, but we need also to talk about workers that may still have a job, but want to better themselves.

And, no, I don't think it is too late with 50 year old people. Many 50 year old people have a great capacity for learning and we should provide them with that opportunity.

Now, fortunately, in our business, worker displacement and retraining has not been a major problem.

While in recent years, we, along with most firms in the electronics business have had to have layoffs, we have worked very hard to protect people with several years of service.

One of the few places that we have had the start up problem that you talked about with regard to the steel industry is with relatively unskilled labor. Many employees that 30 years ago started out building semiconductors by hand have not chosen to take advantage of the training and educational programs available and they have become a problem.

Senator ROCKEFELLER. Mr. Chairman, I see my time is up. I also have a statement I would like to put in the record and I will have more questions in the next round.

The CHAIRMAN. Without objection, of course.

Senator Daschle.

Senator DASCHLE. Thank you, Mr. Chairman.

I want to commend both of you on your excellent statements. Each group of witnesses we have had have brought another dimension to the discussion about trade and you certainly have added again to that this morning.

I would like to ask Mr. Robinson, if I could, if you know the value of the services exported to foreign countries, the so-called service industry, what was the value of it in 1986?

Mr. ROBINSON. I don't know that the 1986 numbers are out, but, as Mr. Shepherd said, it is in the 20 to 25 percent range of total trade. That would put total trade in services in the $400 billion category.

Senator DASCHLE. You were advocating earlier that services ought to be included in GATT. How do you see that as an advantage for it? Could you elaborate?

Mr. ROBINSON. Now there is no place to go if you are in the service industry and you are discriminated against. Discrimination can range from restrictions imposed under the guise of privacy to requirements that businesses use local computer facilities of local owned companies. It can impact the freedom with which you can transfer information across borders. And, incidentally, that is a big threat to manufacturers of goods as well. There is a whole host of service barriers and no home port to take it to.

So we have been arguing that there should be a general framework developed for services, under GATT, which would provide the same sort of dispute settlement procedures that goods have. In addition to that, we should actively utilize bilateral negotiations as well as section 301 to push for right of access to markets, right of establishment, fair treatment within markets, all of the kinds of trading principles that also are relevant to a goods environment.

Senator DASCHLE. Mr. Shepherd, do you have anything to add to that?

Mr. SHEPHERD. No, I don't.

Senator DASCHLE. The impression I have, and I am just a novice learning a great deal as I attend these hearings about the way various elements of the trade package are treated under policy. But the impression I have is that the services part of our trade posture today is somewhat of an orphan in policy. There really isn't a place for it. Is that your thinking? Would you share that view?

Mr. SHEPHERD. Yes, I agree with that.

Senator DASCHLE. How, in terms of our own domestic policy making, outside of GATT, would you treat services as opposed to the way they are treated today?

Mr. ROBINSON. Well under the free trade agreement with Israel, for instance, we have been working on a specific service component. We are trying to do the same thing in the negotiations with

Canada. Services should clearly be on the agenda, with the same kind of framework put forth, and the same kind of detailed definitions put forth as with goods.

Senator DASCHLE. Is it not true that when we are told on a fairly regular basis what the size of our trade deficit is that services are not calculated in that figure usually when you read them in the newspaper?

Mr. ROBINSON. Well usually the newspapers are referring to the manufacturing trade deficit. There has been a trade surplus in services. That has been declining. Of course, included in the services number is investment income. Because of the massive shifts of wealth, caused by the domestic budget deficit, and the financing of it, and the ownership by foreigners of U.S. securities in order to finance that, those numbers are shifting dramatically.

Senator DASCHLE. I am not sure I understand. Go ahead, Mr. Shepherd.

Mr. SHEPHERD. I think an important point that is overlooked more often than it is thought about is the intertwining of services and of manufacturing. In our own in-house operation, we suffer from the limitations on transmission of data that Mr. Robinson referred to between countries, as one example.

Senator DASCHLE. How can that be rectified?

Mr. SHEPHERD. Well, hopefully, by finding its home port, that Mr. Robinson has talked about, in GATT, and giving services the same place in the sun as merchandise has.

Senator DASCHLE. But let me just, in my final question, make sure I understand.

When that current trade deficit is reported to the general population, it is my understanding that services are not included in that; that you can find out what the adjusted trade deficit is, including services, but generally as a reporting measure, services are not included.

Can you give me the historical basis for that kind of practice?

Mr. SHEPHERD. I would suppose it is just because services are relatively new and they just have not been included in the multilateral trade discussions.

Mr. ROBINSON. Well it also depends on which components. Are you talking about overall balance of payment figures?

Senator DASCHLE. That is correct.

Mr. ROBINSON. Or are you talking about current accounts? Are you talking about the merchandise trade deficit?

Senator DASCHLE. Well it is included in the current account, but it is not included in the overall trade balance.

Mr. ROBINSON. Most of the focus has been on the merchandise trade account, because that is where the big problems of dislocation in the United States have been. The media will pick and choose, but most of the focus is in that category.

Senator DASCHLE. Thank you both.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman.

I would ask unanimous consent that the opening statement I have appear at the appropriate point in the record.

The CHAIRMAN. Without objection.

Senator HEINZ. Mr. Chairman, I would like to welcome Jim Robinson and Mark Shepherd to the committee. And I want to compliment Jim Robinson's Business Roundtable for producing what is really quite a thorough document dealing with many aspects of international trade and investment that are not totally unfamiliar to this committee. And Mr. Shepherd has been similarly encyclopedic in covering a lot of very important and necessary territory in his statement.

Both of you gentlemen—you, Mr. Shepherd, on page 16 of your testimony, where you talk about non-tariff barriers and lowering trade barriers, and Jim Robinson, in both his statement and Business Roundtable plan—focus on unfair trade practices and the extent to which non-tariff barriers are a significant part of that.

Now in 1979, we in this committee approved the 1979 Trade Agreement Act that put into effect a series of tariff cuts that formalized what had been negotiated in the Tokyo Round. In return for those tariff cuts and the wide, more open markets we granted to other countries, we basically got a subsidies code and a dumping code, and a few other odds and ends. And the question I have for you is, if the general concept of that negotiation was, we will open our markets if others will generally open theirs, did we get taken? Both of you gentlemen are saying there are a lot of non-tariff barriers that have grown up, even as tariff barriers have gone down. Do you want to tackle that one, Jim?

Mr. ROBINSON. Oh, I suppose in many ways that is true. You know, a whole host of things happened, including the running into the period of the tremendously strong dollar. So that is a major part of it as well. But on balance, we were not as tough in our trade negotiations as I think we have become. So I would look at the period that you mentioned and say that, bottom line, the hopes and expectations of a more open market around the world, that we were ahead of the pack.

Senator HEINZ. That is a tactful way of putting it. Mr. Shepherd, would you agree?

Mr. SHEPHERD. I don't think we really got taken in the initial negotiations. I think we let ourselves get taken by a lack of followup through the years and lack of aggressiveness with the opposition.

Senator HEINZ. I couldn't agree with you more. In 1986 I detected a significant improvement, particularly in some narrow sectoral areas, on the part of the Administration in retaliating, taking action against unfair trade practices and non-tariff barriers erected by the merchantilist countries, such as Japan and others. But, by and large, in the six years that the Reagan Administration has been the steward of trade policy, the overall record has been extremely inconsistent, largely ineffective, and on balance, one would have to say that over the last six years there has been an extraordinary proliferation of trade barriers.

Now the question is, what should we do about it? Jim Robinson, on behalf of the Business Roundtable, has made a specific proposal on page, well the summary, which is on page ii of his handout. And it says that, in effect, USTR should have discretionary authority to retaliate unless an international agreement has been infringed, in which case, something has to happen, but retaliation isn't mandatory. But there has to be a process that is initiated.

My question is: How much different is that really from what we have been going through for the last six years?

Mr. ROBINSON. Well I think the difference is in the numbers, $170 billion of red ink. We no longer have the prerogative of simply talking free trade without being a tough negotiator.

Senator HEINZ. Jim, I don't disagree with you. I am not sure I made my question clear enough, and I have got to because my time is about to expire.

What I meant was, the procedure and process that you prescribed in your recommendation, which doesn't require any action to be taken other than process as opposed to, say, retaliation—is what you recommend significantly different from what is on the books and practiced now? And if it is different, how?

Mr. ROBINSON. I think that it is generally the same thing. But the sense in urgency in what we are saying is that if there has been an international treaty violation there must be action taken unless the President overrides it based on national security or some overview that things are beginning to take place which are substantially more favorable to the country. And then if it is not a treaty violation, that the USTR has the discretion to take action. And, clearly, the actions of the USTR in the last couple of years have made it clear that they are not reluctant to do just that.

This says that the basic process is okay. Tighten it up some. Tighten it up with some definitions. Make it mandatory in some cases, but get on with it.

Senator HEINZ. Mr. Chairman, I have taken my time. I have to go to the floor for a few minutes. I hope that at some point this morning it would be possible to pursue the second part of what Jim is pointing out, which relates to understanding what constitutes a violation.

You, in your bill, as I understand it, have said we can declare——

The CHAIRMAN. In our bill, Senator. In our bill.

Senator HEINZ. In the Finance Committee bill, which I am cosponsoring. The bill stipulates that we may declare an international violation, in a sense, unilaterally. It is subject to being second-guessed by the GATT. But there is in my mind a need to define further what that means so that we are clear.

And I thank the chairman.

The CHAIRMAN. Senator, we will have a second round of questioning, but I limited it to five minutes because Mr. Robinson has an early flight he has to move out on, another commitment, and I wanted everyone to have an opportunity to make the rounds if we could before he left.

And our next Senator to ask questions will be Senator Wallop.

Senator WALLOP. Thank you, Mr. Chairman.

Let me begin by expressing my appreciation for the general tone of both of your recommendations, which implies a lesson that I hope Congress learns that there is no immediate flipover from the present circumstance to a palmier circumstance that there is no Big Mack solution to this. And in that light, I particularly like the Business Roundtable's recommendations, which are sort of long lived pieces of trade policy rather than immediate and sort of reactionary ones.

I am concerned that we only see one-half of the pack always. I don't know how, but you see the trade deficit, and we talk about that, and we talk about dislocations, and we talk about where jobs have gone and everything else. We never talk about the other side of that cake, which is the amount of capital, the amount of profit and the amount of jobs that have been created by what comes in.

And, clearly, when you take a look at jobs created in the world, while we have lost jobs in manufacturing, we have created more jobs than any of our competitor countries in the last five years. And so we have to, I think, look at both of those before declaring a panic.

What I want to focus on for just a minute is the LDC debt because I think if we can do something about resolving that, we will do more for our trade deficit after the kinds of recommendations that are in the Roundtable's and Mr. Shepherd's.

The problem that I fear, and I need you to comment on it if you can, Mr. Shepherd, is that the tax structure in a general way in which banks are not only taxed but must be accounted, require them to carry loans which were essentially non-performing as performing. In other words, if they write them off, then they declare large losses. Stockholders get upset; accountants get upset. It seems to me that we are pushing them into both: paying taxes on a non-performing loan today for a circumstance they will have to write off anyway tomorrow.

Wouldn't it be better to try to find some means of discounting those, both on the books of the banks and for the LDCs, so that you might possibly get a situation where repayment in some level is a possibility, and where the relief of the enormous burden of debt that each of these companies carries provides them the opportunity for a growing economy?

Mr. ROBINSON. Well, Senator, first of all, I agree with your proper focus on the jobs that are created. There is another constituency out there that we haven't mentioned—the consumer. Some of our own protectionist measures have cost consumers over 50 billion dollars in a year. So it is a balance that you have got to keep in mind.

The LDC situation is critical. It is critical because it has frozen out that marketplace. We, the United States, have felt most of the brunt of that during the past five or six years because of IMF austerity programs. Exports to Latin America are down some 33 percent while our imports from Latin America are up.

Senator WALLOP. Our capital exports are down almost a hundred percent.

Mr. ROBINSON. Well our capital exports are down a hundred percent. Now, fortunately, the Japanese are pumping capital out at the rate of about $130 billion a year. Most of that is coming into safer havens like the United States, but some of it is going to ports that will help access LDCs to the marketplace. That is critical.

Now you raised—you know far better than I—a controversial subject of getting into tax incentives for banks to mark their portfolios to market. There is no question that they are not at market now. In fact, there is a trading market that generally will discount anywhere from 15 percent to 80 percent of the face value of the securities. It is a very thin market, but, nevertheless, it is one that is growing.

I think that allowing secondary trading to begin to pick up, and allowing the debt equity kind of swaps that are beginning to take place, are steps in the right direction. Certainly if you provided some accounting and/or some tax incentives, it would take place faster. That is a tough political hurdle to get over, but it is a fact of life.

Senator WALLOP. Well it is. But, clearly, those economies can never crawl out from under their burden unless something like that ultimately happens. We know that ultimately the economy of the world will force it to happen. If, knowing that, it just seems to me that we had better come to grips with it sooner rather than later because those economies, once expanding, provide a tremendous outlet for U.S. goods that are not clearly impossible today.

Mr. ROBINSON. Not only do they represent large and growing markets, but without the opportunity for economic growth, you have the specter and problem of political turmoil and turnover in a number of countries, some of which are very close to the United States.

Senator WALLOP. Thank you.

The CHAIRMAN. Well we may not lose continuity in questioning. [Laughter.]

Senator Bradley, I understand you have some interest in the subject.

Senator BRADLEY. Mr. Chairman, let me ask Mr. Robinson and Mr. Shepherd, both of you—and particularly Mr. Robinson speaks with some authority on the services sector—and you want desperately to get access to the markets of major Third World countries. As you know, at the discussions in Uruguay on the next round, essentially Brazil and India basically vetoed making services a part of the new round. And the question is: What do you think could get them to reconsider? And as you look at the possibilities, one thing might be if the Europeans gave them access to their agricultural markets—I don't think that is going to happen— maybe here, if we give them access to this market or that market in a sector. What I wan to ask you is, do you think that we would have more leverage in getting access to the services sector in Brazil if we made a part of the negotiation the willingness to provide some debt relief to Brazil? In other words, you get some debt relief if you open your market to our services. Do you think that is a reasonable trade off?

Mr. ROBINSON. It should get their attention. Anything that brings down the outstanding indebtedness of the LDCs is a step in the right direction. However, we have got to be careful not to just bring it down without seeing some sort of change on their part in terms of opening up their markets and allowing foreign investment. Otherwise, you simply run the debt levels back up and nothing has been achieved.

Senator BRADLEY. Mr. Shepherd.

Mr. SHEPHERD. Well your problem in the two countries you mentioned, of course, is not limited to services. We still have some benchmarks to get through in being able to take manufactured products into those countries. Services have certainly locked cold.

They have been one of the hard-liners and clearly were at Punte del Este.

Mr. ROBINSON. You said, what can we do? I am meeting with the Brazilian ambassador to Geneva tomorrow, in Geneva, to——

Senator BRADLEY. Well, try out the idea.

Mr. ROBINSON. Yes, sir.

Senator BRADLEY. Let me know what he says. [Laughter.]

Mr. SHEPHERD. Just to not lose a point——

Senator BRADLEY. No, no. I understand your point.

Mr. SHEPHERD. Informative type of equipment—computers, semiconductors—are locked cold in Brazil too.

Senator BRADLEY. I understand.

Mr. SHEPHERD. And to a certain extent, in India.

Senator BRADLEY. Now the next question I have relates to Japan's capital outflow, which I think you put it something like $130 billion. But it is really the beginning of a kind of surge of capital outflow. If you look at the Japanese savings rates and the amount of savings that they have, if you just take the postal saving system, last year they made a change in a regulation. For the first time in history they allowed $12 billion out of the postal system to flow out of the country. The total savings in the postal system is $600 billion.

Now if you take what they have allowed to flow out of the country in the insurance industry, and you extrapolate that over to the postal saving system, they could have a $120 billion flow out.

Now the question is: Where do you think that $120 billion would go?

Mr. ROBINSON. Well, first of all, I think the Japanese are heading in a positive direction by increasing the allowables of foreign investment by the institutions, by recycling those strong savings. The world needs that.

Now, to date, most of the capital has gone into U.S. denominated securities or into the Eurocurrency markets. An increasing amount is going into direct foreign investment in setting up plant facilities here and elsewhere. That is a positive development too.

Senator BRADLEY. If you had $100 billion more flow into dollar-denominated assets, that would simply push the dollar back up and the result would be to worsen the trade deficit. How do we get the Japanese increased savings to flow into Third World countries?

Mr. ROBINSON. Well most of the savings flow that you are talking about is in the private sector. It is not government-owned funds. So the question then becomes: How can the Japanese government induce those monies that are coming out into higher risk instruments? And there are a number of instruments that are being considered now, some of which we are talking to the Japanese government about.

Senator BRADLEY. With the infrastructure there to absorb 50 to 60 billion dollars in high risk instruments?

Mr. ROBINSON. In the developing world?

Senator BRADLEY. Yes.

Mr. ROBINSON. No.

Senator BRADLEY. How much do we get into the developing world, given the present financial infrastructure?

Mr. ROBINSON. I don't really know. I would guess you would be lucky to be getting 10 percent. I am not so much worried that just the Japanese outflow is going to send the dollar shooting back up. The dollar relates to the fundamentals that relate again to the budget deficit here, et cetera.

The Japanese government has increased its own commitment to the World Bank, the IDA replenishment and so forth, in an accelerating and increasing amount. That is very positive. They are also working to have their own export-import bank finance Third Country to Third Country kind of exports. That is positive because it helps developing countries have access to financing they otherwise might not. More and more of that has to be done on a non-tied basis. The Japanese government knows that and are moving in that direction.

The question is: How do you encourage the private sector to change the nature of their instruments so that it is not just hot money which can go out like that but goes into job creating kind of facilities? That is happening in the United States. Some of it is happening elsewhere. A debt equity swap was used to encourage Nissan to establish a facility in Mexico. That is an example of the sort of thing that I think is beginning to happen more and more and that is positive.

Senator BRADLEY. Thank you. My time is up.

The CHAIRMAN. Thank you very much. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Robinson, how much of our "competitiveness problem"—by that I mean just our trade deficit—is due not only to unfair foreign trade practices, not only to a higher U.S. dollar, and not only to the U.S. budget deficit, but also to just failure of the United States companies to produce a better product, pay enough attention to quality, enough attention to marketing overseas, and improving productivity here at home. How much of the trade deficit, in your judgment, is due to this category of problems, i.e., quality, productivity, et cetera, in addition to the dollar exchange rates, unfair foreign trade practices, and the U.S. budget deficit?

Mr. ROBINSON. Senator, I have no idea. It would be unfair for me to try to put a specific figure on it. I would generalize and say that clearly it is a consideration. However, it is not an across the board consideration. It mostly is in the goods area. There are a number of U.S. companies that are highly competitive in terms of being cost effective and being able to determine market demographics, et cetera, in foreign countries.

So it primarily was the high dollar that hurt and lack of access to markets. But, most assuredly—and my father used to always say, I don't care how well you have done something today, you can do it better tomorrow. And we have kind of forgot that in this country over the past number of years, but we are getting it back.

Senator BAUCUS. How aggressively do you think foreign countries will market their services in this country, particularly financial services?

Mr. ROBINSON. Very.

Senator BAUCUS. Frankly, that is my experience. I can tell you that in my State of Montana I am surprised at the number of times that people tell me they have been approached by a foreign bank to do business in Montana. I doubt that the major banks in Montana have correspondingly gone overseas with the same frequency.

Mr. ROBINSON. I would think that is a safe bet. You have a great number of attractions in your state, but that is absolutely true, especially the Japanese, but also the Germans and the French and the British are becoming increasingly——

Senator BAUCUS. You have named the countries and are exactly right.

What is your response to those, particularly in organized labor, who say this is great. We talk about the trade deficit, and it is great that a lot of American companies are trying to figure out how to do a better job at home, but a lot of U.S. companies, particularly the multinationals, are going offshore and jobs are going offshore. What is the Business Roundtable response to that argument?

Mr. ROBINSON. Well it doesn't accept it. I think that if there is access to markets abroad that there can be job growth in this country as well. A lot of the job growth has come in the new technology kind of areas. That is especially the case for services. So I don't think it is simply a question of exporting jobs.

Senator BAUCUS. What can we do here to make sure that we accommodate global American companies who legitimately should have operations overseas, maybe buy and sell within their units, but at the same time provide more high paying jobs for Americans here at home?

Mr. ROBINSON. Well I think the whole mix of suggestions in the Roundtable paper is aimed at doing that, which says that the Administration and Congress have to make this a high, high priority, and work with the business community, and labor, and so forth, to make America more competitive; to deal with a faster speed of dispute settlement, and so forth; to be a tough trade negotiator; to stand up for American access to markets abroad. All of this should contribute to the objective you have in mind.

Senator BAUCUS. Some have suggested American companies are a little less American than, say, Japanese companies, German, Korean, et cetera. That there is less national loyalty among American companies to America, by trying to find jobs in America and increase the standard of living of American workers than other companies that are headquartered in corresponding countries.

Mr. ROBINSON. I don't know whether that is so much the case today. I think, following World War II, where we were the only game in town, that in many ways those countries and their companies and their institutions had to react that way. But now you have got essentially an equal balance, whether it is Europe, whether it is North America, whether it is Asia, in terms of the distribution of wealth and the economic horsepower of those countries. And with that I think there is a lessening of that gap, although it probably is still an appropriate generalization.

Senator BAUCUS. Let me ask a quick question because my time is about up. And that is the degree to which, in your judgment, competitiveness is due to America's—congressional and the private sector, particularly business short attention span. We are looking too much at the here and now and not enough at planning a little for the future. In response to that, I wonder if you would comment on the problem between the manufacturing sector and the financial services sector. The financial service sector is doing well because of deregulation of national services and the stock market. Responding to the recent legal changes, the manufacturing sector is opposed and looking at the long term so it doesn't have to pay as much attention to quarterly parts and can plan a little more.

Mr. ROBINSON. Does that red light mean you are out of time or I am out of time? [Laughter.]

Senator BAUCUS. Well it is up to the chairman.

The CHAIRMAN. Let me do this, Mr. Robinson, because I promised you you would get out of here at 10:45 and that time is now. I wonder if we could just take your statement for the record on that in response to the question, and I might let Senator Chafee ask one question of you and then finish up his questioning with Mr. Shepherd and then we can 'et you be dismissed.

Mr. ROBINSON. Yes, sir, Mr. Chairman.

I think that without a short term there is no long term. Managing a company has to be a balance between the two. Any company, regardless of whether it provides goods or services, that overly focuses on short term is going to be in trouble. I know what we do in our company, to be sure that we are investment spending. It is a substantial number.

Sometimes the media overly focuses on the quarterly results. And you have got to scramble hard to overcome that. It is a phenomena more tied to United States markets than any other market in the world.

As far as financial services are concerned, the globalization of the world capital markets has been made possible by telecommunication and data processing technologies. In our company, at least in the United States, for every two employees we have one CRT. This is a business that is highly mobile, that is indeed developing around the world. So that has benefitted our particular company. So we try to keep an emphasis on both.

The CHAIRMAN. Thank you, Mr. Robinson.

Senator Chafee.

Senator CHAFEE. Mr. Robinson, why don't we do this. The chairman said you could be out at quarter of. It is quarter of. You have to be out at quarter of, or can you give us a little slack?

Mr. ROBINSON. A little slack.

Senator CHAFEE. All right, a little slack. Why don't we just do this. When you have to go, you just go, and I will ask my questions. [Laughter.]

First, on page 8 of your testimony you state, "Japan has taken steps to open a number of markets, including its financial markets." Do you feel that strongly? I mean, we are looking at you as a businessman who does business there and you are finding that?

Mr. ROBINSON. Senator, the answer is absolutely yes. I think they are suffering in many ways from the echo effect of the way they have operated through the years. But by the same token, simply the opening of the market doesn't guarantee that the product is going to get to the consumer. That is going to be a longer term proposition. But they are taking steps to allow access. They are reducing tariffs, like in tobacco. The development of the overseas banking facility which was established last December is now a hundred billion dollar kind of facility. So a number of things are being done.

Senator CHAFEE. What do you mean when you say, "Just as the United States has assumed the major responsibility for military security, Japan can make a greater contribution to the world's economic security"? What in particular are you driving at there?

Mr. ROBINSON. Well I have had fun during the past year with the statement that it is time to redefine national security. National security, if you really think about it, not only means defense budgets but it also means economic growth. If you look at the percent of monies that we spend on defense dollars and foreign aid—it is roughly six and a half percent—and you compare that with Japan's expenditures in those two categories which total about one and a half percent, there is a 5 percent difference. When I first made this speech in Japan, I applied that 5 percent to their gross national product and came up with the then exchange rate of $60 billion a year. There was a shortfall in Japanese spending for their own national security. Therefore, they had the opportunity to invest a substantial amount in the soft dollar side of economic security. The speech got headlines; it got attention. It was designed to be dramatic. But, nevertheless, it has been useful at the higher government levels and business levels in getting the Japanese to focus on the fact that they need access to world markets more than we do. They are the largest creditor to the world. They are the second largest net investor. They have gotten substantial assets to protect. They have as much an interest, or more, in a system of world trade that is growing, and that has stability, than we do. Therefore, they need to come up with substantial programs to recycle capital inflows, the sort of thing we were talking about with Senator Bradley. They are looking at a number of those areas now and are doing a number of things.

One of the things they did was to raise the limits in the postal savings and other savings institutions from 10 to 25 percent of the allowables on direct foreign investment. There is a laundry list of things that they have been doing. I think that that is a perspective that we all should keep their perspective in mind. As George Marshall said, "Without economic growth and prosperity, there can be no lasting and assured peace." And that is a simple equation.

Senator CHAFEE. I know that the Roundtable has some recommendations for specifics that we can do to improve our international competitiveness, and I look forward to seeing those because we are anxious to do something more than just talk about it.

As you know, Mr. Darman, who is greatly respected by this committee, gave a rather severe talk on American businesses' conduct and management. You touched on that in an answer to Senator Baucus. What about that? Has management got to pull up its socks to a far greater degree than they are?

Mr. ROBINSON. Well I think Mr. Darman may have used a few adjectives that he didn't need to use. But, by and large, the charge that U.S. business has got to get tougher, leaner, more ready for the Super Bowl is true. It is always going to be true. That is a challenge we ask ourselves every month when we get together to review the figures.

So I think a lot of what he had to say in his statement was appropriate. Some of the rhetoric perhaps was overdone, but it got attention.

Senator CHAFEE. Well, finally, Mr. Chairman, I would hope that as we get into the specifics on competitiveness, we look at the Business Roundtable's recommendations. Perhaps Mr. Robinson could come back and go over the specifics because clearly some of the recommendations fall under the jurisdiction of this committee. Everybody is for competitiveness, but we need to get to the specifics of what to do, and your help on that would be of great assistance to this committee, certainly to this member. Thank you.

Mr. ROBINSON. Thank you, Senator. And I should say that the roundtable regards this as a working paper. I think that in the trade area, the quality of staff is substantial. And we have a number of staff people working for us, professionals who know your associates, who are backing you up and working with you. We are very anxious to try to be part of a solution, a constructive solution. We look forward to that opportunity.

Senator CHAFEE. Thank you.

The Chairman. Mr. Robinson, we are very pleased to have you. And I assume this engagement that you had was not a tee off time with some Treasury official. [Laughter.]

Mr. ROBINSON. Senator, my handicap has gone from 3 to 9 in the short period of time.

The CHAIRMAN. Well my handicap is mostly my attitude. [Laughter.]

We are delighted to have you and thank you very much.

Mr. ROBINSON. Thank you, sir.

The CHAIRMAN. And I am going to have to go to the Space Committee for a short time, and I will ask Senator Baucus to preside. And I recognize Senator Durenberger.

Senator DURENBERGER. Mr. Chairman, thank you very much.

Mr. Shepherd, I think this is a general sector of the economy that is represented on this committee its natural resources, and we see that at various times in tax policy and other areas. I bring it up only because one of the natural resources in my state, the American Mining Congress, is in town now, and yesterday I spent some time with some of the presidents of some of the ore companies talking about the future. And I think I was impressed by the fact that getting at a question of you, which is short-term, long-term, and does America have the capacity to look long-term and deal with private business institutions have the capability of dealing long-term, and what is government's role in that?

We sat, for example, and we talked about what should happen in iron ore and steel in America. And then we talked about what is happening. Chapter 11 bankruptcies either bringing about other Chapter 11 bankruptcies or bringing down a whole industry. We talked about dumping tens of thousands of very generous pensions on the Pension Benefit Guaranty Corporation, and some of this sort of heavy kind of stuff which I haven't noticed we,—you and us—having the capacity to deal with very readily. We can point out the problems. When tax reform time comes along, we can debate what role the ITC has, and this, that and the other thing. But I haven't sensed in the years I have been here that I am living in a forum that has the capacity to deal mutually between the private and the public sector in the long haul. And I wonder if that is just maybe an American problem, and we cannot do anything about it, or whether you might have some suggestions for us as we reflect on Dick Diamond's critique and just general? I mean a lot of this critique has come from within the American business, the critique of short-term thinking and so forth.

But I am assuming we have some role in that also, that maybe we stimulate it in one way or another. So if you have some thoughts to give us on that short-term versus the long-term, and profit consciousness, and how we aim at profit consciousness, and so forth, I would appreciate that.

Mr. SHEPHERD. Well I certainly think that these segments of American business have the wherewithal to think long-term. In fact, I believe that is indeed where most of us spend a fair amount of our time. The people that are leading a company should be spending 75 or 80 percent of their time in the long-term trying to construct strategies for the future and scenarios for the different potential upsets that come along.

Unfortunately, we are not always smart enough to write as bad a scenario as sometimes happens to us.

There certainly are short-term pressures on us, particularly on publicly-owned companies. Our stock market has a horizon of about one calendar quarter, primarily because of the large institutional holdings. And this is exacerbated by the requirements for the money managers that are handling those funds—they must make their mark every quarter. So if you are not in there producing every quarter, you suffer a great deal in the marketplace. And that is not just suffering of the shareholders, it is a suffering of the company because it makes your cost of equity considerably higher.

I would suggest that there might be some things Congress could do to make that capital a bit more patient. Much of those funds are pension funds that are tax free. Maybe they should be taxed if not held six months or a year. Maybe they should not have a vote if not held six months or a year. That might stretch our horizon.

The impatience of the stock market and the real tax advantages that some of our competition, in particular, the Japanese, Koreans and the Taiwanese, are going to have because of their debt equity ratios are serious concerns. They can get by with a 1 to 2 percent profit after tax. We need 5 or 6 percent because of our stock market "disconnect," as I call it.

In the case of a company the size of mine, about a $5 billion company, compared to its Japanese competition, right there the Japanese company gets 400 or 500 million dollars more a year to fritter away or to spend on more long-term factories, or whatever.

Senator DURENBERGER. Thank you.

Mr. SHEPHERD. But I think it is very important, and I want to leave this word. I think that American business does have the capacity to think long-term and much of it does think long-term.

Senator BAUCUS. We will start with the second round of questions. Senator Bradley.

Senator BRADLEY. Thank you, Mr. Chairman.

Mr. Shepherd, a Japanese executive recently said that he who dominates software dominates the world. What do you think he meant?

Mr. SHEPHERD. Well I would suppose that he means they are going to target software and come after us in that area. I think that software has some peculiar characteristics, and it may be much more difficult for the Japanese, Taiwanese, Koreans, and so on, to dominate that market than they think.

Software often has a very tight connection to a specific local problem that, fortunately, we would understand much better than they do. Before one can write software one must have a problem to solve. And those problems have great variations around the world. The same set of problem solutions that work here will not work in Japan, will not work in places in Europe.

Senator BRADLEY. Can you give me an example?

Mr. SHEPHERD. Any data processing system, your payroll systems, your receivable system, and on and on. In particular, design automation systems and computer controlled factory systems.

Senator BRADLEY. But does that tell you at all that what he was saying is, look, the objective is to dominate software? The objective is no longer steel and other manufactured goods.

Mr. SHEPHERD. Well I don't think there is any question. The Japanese are much more adroit at scuttling sunset industries than we are and moving on to sunrise industries. And I think that that has been in their scheme of things for a long time and they will continue to perform that way.

Senator BRADLEY. When you look at the pattern of Japanese capital flows—and you heard Mr. Robinson earlier say, you know, they should put more money in these countries -- what we are doing is essentially selling Treasury bills. What they are doing is investing in Brazil, and Mexico, and Southeast Asia in companies' plants that will produce goods.

Now do you then think that our competitors 10 years from now will not be the Japanese producing goods in Japan for export to the United States, but will instead be Japanese owned companies in various parts of the world producing goods that will be coming to the United States, while, in the interim, the only thing we have been able to do with our capital is pay interest?

Mr. SHEPHERD. Well as a nation, maybe you can make that very broad statement. I think we must recognize that for, well every since World War II, business in the United States has been busily engaged in placing factories in other parts of the world, in Europe, in South America, in the Pacific Rim. Admittedly, some of the plants that went into the Pacific Rim were to try to give us a handle to compete with a low labor cost that the Japanese and our other competitors in the Pacific Basin had.

I think the Japanese in the next decade will indeed begin to develop so many of the same problems that we have. Their work ethic is going to slip a bit. They are going to have a very difficult time maintaining the almost terrible dedication that the young people have had in the past. And that is beginning to slip as well.

Senator BRADLEY. But that assumes that you still are running a plant in Japan with a Japanese work force. What if you are running a plant in Brazil with a Brazilian work force?

Mr. SHEPHERD. Well if you run a plant in Brazil with a Brazilian work force, you have to have the same kind of dedication in your national, your home base employees to make sure that the systems that you won't get to that plant, that the manufacturing techniques that you won't get to that plant, and on, and on, and on.

Senator BRADLEY. So what are the problems you see, that they are just moving into a different cultural environment, different work ethic, different standards, and, therefore, they will have the same problems we have now. And, therefore, what?

Mr. SHEPHERD. Therefore, they will be sitting around in the Japanese Diet 10 or 15 years from now at a meeting just like this. I am serious. I think they are going to have those kinds of problems. I am much more concerned about the target moving from country to country than I am about the Japanese being able to consolidate and hold their present advantages. India is going to be a big problem for us. China is going to be a big problem for us. And many of the other smaller countries in the Pacific Basin will be a problem.

Senator BRADLEY. You mean as competitors?

Mr. SHEPHERD. Yes.

So the problem that we are zeroing in on now is that Japanese being a problem. If we solve that problem, the problem is not going; it is just going to move.

Senator BRADLEY. But doesn't the problem remain as long as our capital is simply going and our savings is simply going to pay interest on debt; that we are not going to have the capital to begin to compete with anybody, whether it is China or Japan or Taiwan?

Mr. SHEPHERD. Well at the moment, as you well know, we don't really have any capital available because the demands of the government, the whole savings rate, and on and on.

Senator BRADLEY. That is my point.

Mr. SHEPHERD. But somehow we are continuing to grow and expand our business. So we can go borrow money in other countries as a company if we have to.

Senator BRADLEY. Thank you.

Senator BAUCUS. Thank you, Senator Bradley.

Mr. Shepherd, following up on this topic, a lot of commentators say that one reason we are having a problem in America is because of a low personal and corporate savings rate, except that if a corporation saves, it can become the target for hostile takeover. Public savings is so low, it adds to our big budget deficits. Yet, you say we are doing all right as a country. I guess it is because we are consumption oriented, and have a consumption engine driving our national economy. Other countries have less of a consumption engine but more of a productive engine that they export.

Are you saying that we in this country should draw the line away from consumption and a move toward production and increasing savings, public and private. Therefore, more quantity of investment, and theoretically lower costs of investment if we are going to have a higher standard of living for ourselves and for our children as we enter the next century?

Mr. SHEPHERD. I think, as outlined in my introductory remarks, it is imperative that we take steps to let us move more toward an investment in a savings sort of economy. And attached to the full copy of our statement is a thing labeled "The Dos and Don'ts of Trade Policy." And let me just read through those briefly.

It is lower the cost of capital. We have got to put downward pressure on interest rates by reducing our budget deficit. We must increase capital formation by resurrecting the investment tax credit, by repealing the double taxation of dividends and by lowering tax on capital gains. We must encourage savings by getting rid of taxes on savings. And I think we can do all of that and offset the revenues that are lost with a tax on consumption.

I am separating this from the present budget deficit and tax subconsequences and so on.

And we need to increase our incentives for private R&D. And there are a number of things that we can do there. And we need to work hard at making trade a two-way street.

And I have tried to keep your attention on the education problem that we have in this country. We just must do something that raises the standards of our educational system, both at the primary and high school level, and in the universities.

Senator BAUCUS. On that point, could you give me some examples of how that would affect your company?

Mr. SHEPHERD. Well let me go back to Japan again. And we are quite familiar with Japan. We have big operations there. We have about 7,000 employees in Japan scattered in four plants.

When youngsters come out of our equivalent of high school in Japan, they have had physics, they have had some biology, they have often had math through early stages of calculus, and they may have even had some vocational training on top of that. They are well equipped to enter the manufacturing work force. And, of course, that is not by accident because a much higher percentage of Japan's GNP is in manufacturing than is ours. And I think that is one of their very great competitive strengths.

They generate enough engineers, that when an engineering graduate comes to a company he doesn't go into the lab. He goes out and serves a 2- or 3-year apprenticeship on a drafting board or in the shops, maybe even in a machine shop. And the leverage that that gives the quality of the work force is just enormous. It is just enormous.

Senator BAUCUS. What thought has the American business community generally, and this Business Roundtable—given to developing concrete proposals for increasing education in America. What degree of private enterprise is going to help raise the educational standards so that our high school kids have enough years of physics, math, et cetera?

Mr. SHEPHERD. I don't know that there is an educational task force in the Roundtable at this moment, so I am not sure that the Roundtable has any specific recommendations. We recommended earlier in our discussion some things that we think need to be done

To start with, we need to establish some higher standards for our local school boards, and I suggest that maybe the federal government should find a way to do that. I know that is a touchy local rights issues, but we are not doing much about it at the moment.

In the State of Texas about two years ago we had a sort of a quality education committee that made a number of recommendations that have begun to permeate the system. The most controversial one was that football players had to make passing grades.

Senator BAUCUS. Yes, we noticed that. Thank you. My time is up. Senator Chafee?

Senator CHAFEE. Thank you, Mr. Chairman.

Mr. Shepherd, I think the points you make obviously are good ones, and many of them are directed at the Congress, particularly when it comes to dealing with the deficit, which you and I think every other witness that has come before us, or practically every other witness, has said it is the principal cause of the trade deficit. And so obviously we have got to do a better job here. But let me turn to the part you stress on the transfer of technological progress from the R&D stage to the manufacturing equipment and processes, on page 9.

"We have been weak in executing the difficult transition from R&D prototype to full-scale commercial production."

Now it seems to me that there it isn't government that has to do something. Isn't this right back into your own ball park, namely, the manufacturing side or the management side? And what seems to be the problem? I mean, it seems to me it is deeper than the cost of capital, which you touched on in your earlier points. What is the hitch there? And can you name one company or a series of companies that seem to have done an excellent job in this area, from your experience?

First, what seems to be the difficulty?

Mr. SHEPHERD. Well I think one of the problems is that there are too many corporate managements that are devoid of manufacturing expertise. You won't find the employees from the factory floor in very many executive offices, and you won't find them on very many boards of directors. We have got to become much more aware of the importance of manufacturing. We, I think, reached the point maybe 10 or 15 years ago that we felt we were invincible and we didn't need to worry about it any more.

On the other hand, the Japanese have payed a lot of attention to that problem. And one of the reasons they could is that they managed to acquire their basic technology from the rest of the world by various means, with the result that they could spend somewhere around 80 to 90 percent of their research and development efforts on the manufacturing side of the house.

Why don't we do that? Well, we have to make choices between how much we put into basic research, how much we put into private R&D, and how much we put over into the factory. And I think that is beginning to change. But we are still behind the eight ball.

I like to think our company is beginning to cope with this problem.

We have had a problem with the Japanese in a product called the DRAM, where we have been absolutely competitive with the Japanese on manufacturing costs. And we have manufacturing equipment that is equal to theirs, but we can't beat that ball game when we have massive dumping in our markets by the Japanese companies.

Senator CHAFEE. Well there is something that obviously comes into the trade aspects, and we have got to do far better than we have done there.

Is there any other company that is kind of a model that you might think of that has made this, done this transition successfully?

Mr. SHEPHERD. Well I think IBM has done well in this area, like they have done in almost any area. It is hard for me to find companies that I can say have really done this job well.

Senator CHAFEE. Now I would like to go back to the debt and equity situation, which you also touched on earlier. I don't quite see the problem there. Debt, obviously its interest is deductible. But many companies are paying extremely—even companies in your field—low dividends. And so obviously if you are getting equity, and you are not paying out much in dividends, you are getting your capital at the cheapest form possible.

Mr. SHEPHERD. The problem is not, Senator, what we might be getting our capital for. It is what we are getting our capital for vis-a-vis the Japanese. And I would disagree a bit with you on what equity costs us. We regard the price of equity as a cost of maintaining our position in the marketplace. Debt is always cheaper than equity.

If you have 80 percent of your capital in debt and only 20 in equity, as opposed to 80 in equity and 20 in capital, you have got to distort the numbers a great deal for the sum not to come out to be in favor of a highly leveraged operation.

I don't think it is healthy for companies in our system to get as highly leveraged as the Japanese companies are.

Senator CHAFEE. Well my time is just up. But if your yield on your equity is 2 percent or 2.5 percent, as it is in many American companies, I am not quite sure how you can get debt for cheaper than that.

Mr. SHEPHERD. The yield is not on equity. The 2 percent yield compared to our 5 or 6 is percent of profit after tax against sales. And the result of that is that to get a reasonable return on equity because you don't have much equity—it's mostly debt—once you pay your interest, the number required to get your equity return up to a reasonable level results in a 2 percent profit after tax on sales.

Senator CHAFEE. All right. Fine. Thank you very much. Thank you, Mr. Chairman.

Senator BAUCUS. Senator Bradley.

Senator BRADLEY. Thank you very much, Mr. Chairman.

Mr. Shepherd, what I want to do is to try to focus on winners and losers in the trade deficit, and maybe more precisely understand what are the dynamics in the trade deficit.

Basically, would you agree that a trade deficit is essentially that the country that exports to the United States gets dollars for those exports, and they don't spend all of those dollars to buy imports from the United States, but have an excess supply of dollars? Would you agree that is a trade deficit?

Mr. SHEPHERD. Yes, sir.

Senator BRADLEY. The question then is, what do they do with those dollars?

Mr. SHEPHERD. Well, hopefully, they keep buying government securities.

Senator BRADLEY. All right. They have to take those dollars and buy dollar denominated financial instruments or perhaps invest those dollars in the United States in some activity. Right?

Mr. SHEPHERD. Right.

Senator BRADLEY. So would you say that there is a kind of competition here between the industries in this country that sell goods to the Japanese or the Germans or whomever, and when they don't buy our goods, they do buy our financial assets or invest in tax favored investments in this country? Would you agree that there is, therefore, a competition necessarily. If you don't export, the export sector in this country loses. Necessarily the winner are those other industries, financial world, et cetera, that can suck up those surplus dollars. Do you agree with that?

Mr. SHEPHERD. I can't argue with that, no.

Senator BRADLEY. All right.

Then the question is, if we put a lot of tax incentives for investment, won't we be essentially further injuring our goods producing sector in this country?

Mr. SHEPHERD. No, I don't think so because that flow was in a different direction. That flow stays inside of the U.S, corporation and allows you to do more R&D, allows you to do more manufacturing research, and it gives you the working capital to grow.

Senator BRADLEY. But if the Japanese, or we won't pick on the Japanese, if country X is not buying U.S. goods, and has a surplus of dollars, what do we do with this? And then here is a write off of a building in 15 years. And so they say, well, we have got to put it in a dollar investment somewhere. Here is a tax code that allows you, formally, to write it off in 15 years. So you find all of the surplus capital flowing into the United States into commercial office buildings.

Now the investment, if you run a commercial office building, you are in great shape. You have got a great supply of capital, all these surplus dollars in the world. If you are a goods producing industry, however, the more they invest in commercial office buildings the less they will spend on your goods, and the less America will export. Isn't that necessarily the case?

Mr. SHEPHERD. I don't believe so. I would not suggest that you revive 15 years depreciation on such goodies as commercial office buildings. We have had enough of that.

I think the boundary of where that money flows is what is important. If you give me an investment tax credit, you give me an R&D tax credit and so on, that simply provides us more cash flow. It lets us do more things that we need to be doing to make ourselves more competitive in the world.

Senator BRADLEY. I have a big chart. I am not going to get out the big chart to show you today, but let me just give you the numbers. Investment tax subsidies from 1983 to 1986 went from about $25 billion to $65 billion. That is the precise time that the trade deficit went from about $50 billion to $170 billion. Is there a correlation in there?

Mr. SHEPHERD. I do not think so.

Senator BRADLEY. You don't think so?

Mr. SHEPHERD. No. I think that is also a period when—what was your time period?

Senator BRADLEY. 1983 to 1986.

Mr. SHEPHERD. Well that is the time period when the dollar was grossly overvalued.

Senator BRADLEY. So you are essentially making the point that in terms of the trade deficit that the Tax Code can do very little.

Mr. SHEPHERD. No, I am not making that point.

Senator BRADLEY. Oh.

Mr. SHEPHERD. I think that the Tax Code can do quite a lot. I do think that the single biggest item we have working against us is the exchange rate. I do think that maybe the next biggest item we have working against us is the cost of capital, which is tied to our tax structure, and with this thing I call the stock market disconnect that gives my Japanese competitor 400, 500 or 600 million dollars more per year to do the things I would like to be doing: more R&D, more manufacturing research, more product development, more marketing, and so on.

Senator BRADLEY. Could I just ask one quick question, Mr. Chairman?

Senator BAUCUS. Yes.

Senator BRADLEY. What do we do about that stock market disconnect?

Mr. SHEPHERD. That is difficult. You need to find a way to make that capital more patient. We talked about two possibilities earlier, of taxing the tax-free pension funds if they are not held, or don't give them a vote until they hold it six months or a year.

Senator BRADLEY. Thank you very much. It was very helpful testimony.

Senator BAUCUS. Mr. Shepherd, I would like to follow up on the question that Senator Chafee asked. Are American companies basically doing all they have to do to compete better? And you said, well, there are a few, but you can't think of very many that really are.

Mr. SHEPHERD. He asked a more specific question. I made the point that I thought one of our problems was that we had not paid enough attention to the steps between an R&D prototype and high volume production. And he asked me, could I point out any companies that have done an outstanding job.

Senator BAUCUS. Why are so few American companies doing that or doing what they should do?

Mr. SHEPHERD. Well I think that we have forgotten the importance of manufacturing. We have been taking manufacturing for granted.

Senator BAUCUS. I understand that. You have talked about the fact that the factory foreman is not in the executive suite and he is not on the board of directors, et cetera. What is going on here? Why aren't more companies not including him? Is it strong incentives? They disagree with you?

Mr. SHEPHERD. First, I think, very simply, we have taken manufacturing for granted. Second, we do have many corporate managements more interested in manipulating numbers than in developing and producing products. And we must correct those things and I think it can be done.

Senator BAUCUS. But I am trying to ask you why management doesn't focus on that as a higher priority and do something about it?

Mr. SHEPHERD. Maybe it is easier to make money by being a banker than it is by being a manufacturer.

Senator BAUCUS. But what about those CEOs that happen to be CEOs of manufacturing companies? They are not doing apparently what you think they should do. Why aren't they?

Mr. SHEPHERD. Well I certainly can't put myself inside the head of every manufacturing CEO in the United States. I think it has to do some with the short-term orientation that has been discussed. It has to do some with the allocation of your monies between your manufacturing R&D and between your basic research and your product R&D. And then you must decide what distribution you are going to make with funds into marketing. You know, there are maybe ten principal categories of funding that are going in a company. And most people, for whatever set of reasons, do not put enough into the manufacturing side of the ball game.

Senator BAUCUS. Is it because of wrong incentives?

Mr. SHEPHERD. I am not sure that it is wrong incentives. We can't talk about this out of context with the competition. Keep remembering, I keep saying that my competitor in Japan, my size, has got about $500 million more to spend in expenses that I have in any given year.

Senator BAUCUS. Well why is that?

Mr. SHEPHERD. That is again because of the combination of the Japanese financial system, which has the high debt/low equity and we have just the reverse, and also the thing I call the stock market disconnect. Their stock market is much more patient than ours is. And part of the reason for that is that many of the stock owners in Japan are other companies. And they put money in, and want to leave it there and let it grow. You have got the same thing in Germany.

Senator BAUCUS. Do you think that most American businessmen on the production and the manufacturing side, would agree that the Congress should try, in a reasonably constructive way, to provide incentives to make capital more patient?

Mr. SHEPHERD. Yes. I think that would be a good move.

Senator BAUCUS. And how strongly would the financial service side, say, Wall Street, disagree?

Mr. SHEPHERD. They would behead you if they could.

Senator BAUCUS. Well why isn't the manufacturing side speaking up and doing something about it?

Mr. SHEPHERD. Well, we are.

Senator BAUCUS. We are right here. That is good.

And what are some ways, in your judgment, to help capital be a little more patient?

Mr. SHEPHERD. Well it is a shame that Mr. Robinson didn't stay around for this debate. We might have heard some different points of view.

The problem is complicated by the way our shares tend to be owned. As you well know, a large percent of the shares in the United States are owned by institutions, and they all have managers who are beating on the portfolio managers for quarterly results. So they are going to do everything they can to make that game look better at the end of the quarter.

That has the disadvantage, of course, to us of making our capital not very patient.

I think one—and I did float this in Wall Street about two years ago and I have been afraid to go to New York ever since—you could just tax the non-taxable funds. Most of that is in pension funds and such trust funds. And if you would tax them if they didn't hold the product for some period of time—six months, maybe a year—or have a sliding scale if they got down to zero tax, I think that would help.

You might not let stock become eligible for having a vote for some period of time, like six months or a year. And I am certain their financial people would come up with much more clever plans than that.

Senator BAUCUS. Well, I appreciate that, Mr. Shepherd. Those are two ideas that I have heard of as well, and I frankly think deserve very serious consideration. It is clear to me that among the multitude of answers here to make our country more competitive one of them is to help encourage the development and utilization of capital, and be more patient, in your terms, than we are now.

Maybe we have to approach this in the way the Japanese did. They didn't become an economic power overnight. They took it a step at a time. And I think that we in this country have to as well. It is going to take many years for us to turn this around, but you put your finger on one step of a multitude of steps, which we have to seriously look at.

Well I am finished, and I see everyone else is too. So the hearing is now in recess.

[Whereupon, at 11:33 a.m., the hearing was concluded.]

MASTERING THE WORLD ECONOMY

THURSDAY, FEBRUARY 5, 1987

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The Committee met, pursuant to notice, at 9:35 a.m. in Room SD-215, Dirksen Senate Office Building, the Honorable Lloyd Bentsen, Chairman, presiding.

Present: Senators Bentsen, Matsunaga, Moynihan, Baucus, Bradley, Riegle, Rockefeller, Daschle, Packwood, Danforth, Chafee, Heinz, and Durenberger.

[The prepared statement of Senator Heinz follows:]

STATEMENT OF SENATOR JOHN HEINZ, COMMITTEE ON FINANCE HEARING ON TRADE POLICY, FEBRUARY 5, 1987

Mr. Chairman, this is the fourth in a series of hearings examining the condition of U.S. trade policy and the need for further legislation. Today's witnesses represent various segments of the business community, and I hope they will discuss some of the problems they face selling overseas and in dealing with unfairly trade imports here at home. Bob Galvin of Motorola, I know, has extensive experience with both these problems and can shed some light on how other governments and producers manipulate the trading system to create comparative advantage for themselves and distort market principles.

What we are learning from these hearings, Mr. Chairman, is not only the seriousness of the problem but its complexity. Just as there is no single cause, there can be no single solution. Of course we need to reduce the federal budget deficit. Of course exchange rates are a problem. Of course LDC debt curtails our trade opportunities. But it is becoming increasingly clear that unfair practices and other efforts to manipulate the system are also part of the problem that needs to be addressed. I hope today's witnesses will show us how to do that.

D R A F T

SUMMARY OF THE OMNIBUS TRADE ACT OF 1987

February 5, 1987

Section 1: Short Title.--The short title of the bill is, "The Omnibus Trade Act of 1987."

Section 2: Table of Contents.

Section 3: Purposes.--The purposes of the Act are to authorize negotiation of reciprocal trade agreements, strengthen U.S. trade laws, improve management of U.S. trade strategy and, by these means, to improve standards of living in the United States.

TITLE I -- AUTHORITY TO NEGOTIATE TRADE AGREEMENTS

Trade negotiating authority is made the first title of the bill because this subject has traditionally been the most important in trade bills and offers the greatest opportunity for improvements in U.S. living standards.

Section 101: Congressional Findings.--This section sets forth findings that support a delegation of negotiating authority to the President. It is based upon the "findings" that served as the predicate for the Trade Act of 1974, but it has new elements, reflecting changed conditions in the United States and world economics.

Section 102: Definitions.--This section provides necessary technical matters.

Section 103: Authority for International Trade Negotiations.--Subsection (a) authorizes the President to negotiate multilateral trade agreements. The authority covers tariff, as well as non-tariff matters. The authority is for 10 years, beginning on either January 3, 1988 or the date of enactment of the bill, whichever is later.

Subsection (b) creates separate authority for bilateral trade agreement negotiations, subject to the general limitations on negotiating authority contained in this Title, such as the requirements for trade agreements set forth in subsection (c), below.

Subsection (c), in addition to placing the 10-year time limit on negotiating authority, sets out prerequisites for all trade agreements negotiated by the President under this authority. The first requirement is that where the President finds "state trading," he determine that action under the trade agreement will be conducted in accordance with "commercial considerations," a term used in the General Agreement on Tariffs and Trade (GATT). The second requirement is that the agreements carry out one or more of the negotiating objectives set out in section 105. In addition, agreements must provide for mutually beneficial economic opportunities, must be enforceable, and must complement and reinforce existing agreements where appropriate and possible. The last requirement is intended to assure that bilateral trade agreements reinforce and expand on multilateral agreements. Finally, the section requires the President to consult with Congress on every step of negotiating, implementing, and enforcing these agreements.

Section 104: Implementing Procedures.--This section sets out a new, three-step procedure for approving and implementing trade agreements. This procedure uses the Constitutional power of each House of Congress to create its own rules to give expedited legislative consideration to bills implementing trade agreements negotiated under this Title. This is intended to encourage extensive consultation by the Executive Branch with the Congress on trade.

Step 1: Statement on Trade Policy.--The first step in this procedure is the submission of a detailed "Statement of Trade Policy" by the President. The statement must include, at a minimum, a statement of Administration policy on the following matters:

(1) General Trade Policy.--The statement must address at least five aspects of trade policy, namely, current trade policies regarding agricultural trade; import sensitive industries; the exchange rate value of the U.S. dollar; the trade-distorting impact of LDC balance of payments deficits; and U.S. and foreign government economic interventions that have effects on international trade.

(2) Policy Toward Export Sectors.--The statement must identify those sectors where the United States is a major world exporter and those sectors where export expansion is likely and describe what policies, if any, might affect the strength of those sectors. This section of the statement must include an evaluation of the potential of foreign producers in the sectors identified.

(3) Policy Toward Import-Sensitive Industries.--The statement must identify those sectors which are experiencing import competition, or may in the future, that would cause major adjustments, such as significant unemployment, a need for relocation, major investment, new manufacturing methods, or reduced profits. It must describe the policies and potential exports of nations where major competitors are located, as well as the policies of the Administration that will affect the competitiveness of those industries.

(4) Related Policies.--The statement must set forth the relationship between trade in goods and other international economic issues, including at a minimum the magnitude of changes in the relative values of the major currencies (and those currencies pegged or tied to the U.S. dollar) international exchange of technology, international investment, and international services transactions, as well as Administration policies for each of these matters.

(5) Developing Countries.--The statement must identify the main developments in developing countries' economies that have an impact upon the standard of living in the United States, and the Administration's proposed actions with regard to each of these. This part of the statement must include, but need not be limited to, developing country indebtedness, developing country import, export, and sectoral policies, developing country economic policies, and developing country relationships with existing international institutions.

(6) International Economic Coordination.--The statement must describe any agreements or other evidence that the United States has obtained commitments from Japan, the Federal Republic of Germany, and other industrialized countries with large current account surpluses to contribute to balanced world economic growth by increasing the share of non-petroleum goods and services imported into their respective countries.

(7) Trade Agreements.--The statement must state the relationships between the policies required above and the negotiations of trade agreements the Administration expects to undertake during the next five years.

Step 2: Congressional Resolution.--Under this section, such statements may be submitted whenever the President chooses. Each statement must be accompanied by the introduction of a concurrent resolution, in a form set out in the bill, on which Congress must act, under changes in the rules of the two Houses that are also part of this bill, not later than 60 days after its introduction on a straight up-or-down vote (the "fast-track").

Step 3: Fast-Track for Trade Agreements.--If Congress approves the statement, then the President is privileged to submit trade agreements negotiated under this Title for fast-track Congressional consideration for a five-year period, beginning on the date the concurrent resolution passes. Under this provision, the President would be able to submit trade agreements for fast-track consideration through the date six months after the termination of his general authority to enter into trade agreements, provided that a concurrent resolution approving his trade policy statement is in effect.

This system is intended to assure close consultation on trade between the Administration and Congress. It is anticipated the Administration would consult, as in the past, on each trade agreement submitted under the "fast-track," and that, further, the Administration would consult closely with the Congress before submitting the "Statement of Trade Policy." The concurrent resolution would be referred to the Finance Committee in the Senate and the Ways and Means Committee in the House.

Section 105: Negotiating Objectives.--This section sets forth specific negotiating objectives for the President. The objectives include obtaining opportunities for U.S. exports in foreign markets equivalent to the opportunities afforded foreign exports in U.S. markets, improving and expanding trade agreements, revising GATT rules to include sectors not presently covered, and improving the GATT's application to agriculture. This section also makes reciprocal access to technology a negotiating objective of our trade agreements. The goal is to insure that the United States has the same access to basic research and technology developed in other countries as our overseas competitors have to technology developed in this country.

Section 106: Effectiveness of Current Law.--Under these provisions, existing negotiating authority (sections 101 and 102 of the Trade Act of 1974) would be allowed to expire by operation of law, and would be replaced by sections 101 through 105 of the new law. Existing sections 103, 104, 105, 106, and 109 ("Sector Negotiating Objectives," "Bilateral Trade Agreements," "Agreements with Developing Countries," and "Staging Requirements and Rounding Authority," respectively) of the Trade Act of 1974 would be repealed as superseded by new sections 101 through 105 of this bill. This section also requires that advisory committees established under section 135 of the Trade Act of 1974 be appointed on a bipartisan basis. Otherwise, in general, the Trade Act of 1974 would remain in effect except as amended by this bill.

Section 107: Extension of GATT to State Trading Countries.--Under this provision, countries proposing to accede to the GATT would not receive U.S. support unless they agree to remove the harmful effects of state trading practices that are not in accordance with the existing "commercial considerations" rule of the GATT itself.

Section 108: Negotiations on Currency Exchange Rates.--This new section would be added to urge the President to enter into negotiations with countries that peg their currencies to the dollar, such as Hong Kong, Korea, and Taiwan, to insure these countries regularly adjust exchange rates to reflect economic fundamentals.

TITLE II: ENHANCING COMPETITIVENESS

Subtitle A: Positive Adjustment in Import-Impacted Sectors

Section 201: Investigations Under Section 201 of the Trade Act of 1974.--This section makes several changes, adapted from S. 1860, to assure that decisions of the U.S. International Trade Commission (ITC) in escape clause investigations determine fairly whether a domestic industry has been seriously injured by increasing imports, or is seriously threatened with such injury, the GATT standard of eligibility for escape clause protection; and that the statute is made an effective system for promoting economic adjustment to import competition. It replaces existing sections 201 through 203 with the following new sections:

Section 201.--This section requires that the petitioner state whether the purpose for which import relief is sought is enhancing competitiveness, facilitating the orderly transfer of resources to alternative uses, or other means of adjustment.

Domestic Facilities.--The existing standard for deciding whether "serious injury," or the threat thereof, exists is amended to provide that the ITC consider "the inability of a significant number of firms to operate domestic production facilities at a reasonable level of profit." (New matter underscored.)

Threat of Injury.--Four new criteria are added for judging whether there is a "threat" of serious injury in such cases, namely:

(a) Instances of industrial "targeting" by the exporting country;

(b) The presence of any preliminary or final antidumping or countervailing duty determinations with respect to any merchandise that is also produced by the domestic industry;

(c) The extent to which the domestic industry is unable to maintain existing levels of research and development expenditures; and

(d) The extent to which articles that are the subject of the investigation are being diverted to the United States as a result of the export or import restraints of any foreign country.

Criteria for "Industry" and Causation.--This section also makes the following changes in the criteria used by the ITC to define the domestic industry and determine causation:

(a) It requires (instead of permits) the ITC to treat as part of an industry only its domestic production, even if the industry also imports the products in question;

(b) It prohibits consideration of imports of like or directly competitive products by the industry as a factor indicating the absence of serious injury or threat thereof;

(c) It requires the ITC to examine factors other than imports which may be a cause of injury or threat thereof. The findings of this examination are to be included in the report submitted by the ITC to the President;

Section 202: Provisional Relief/Critical Circumstances and Perishables.--Subsection (a) of this section provides that if, during the course of a section 201 investigation, the President finds that critical circumstances exist, he shall impose provisional measures immediately. These measures shall remain in effect until they are revoked, or the ITC makes a negative determination, or until 60 days following an affirmative determination by the ITC (at which time the President is required to take action under the regular escape clause procedures). "Critical circumstances" are defined as a "significant" increase in imports (actual or relative to domestic production) over a short period of time, in which delayed relief would cause damage to the industry that would be difficult to remedy under the regular escape clause procedure.

Subsection (b) of this section provides that, with respect to perishable products, emergency relief may be sought by petition from the Secretary of Agriculture, who may recommend, within 14 days, emergency action to the President. Upon receipt of an affirmative recommendation, the President must act within seven days. The purpose of the section is to assure that industries producing perishables, such as fruits, vegetables, and other agricultural sectors, are not injured irretrievably before effective relief can be put into place.

Section 203: Industry Adjustment Plans.--This section provides the mechanism for making the escape clause into a full-fledged adjustment-facilitation statute, a major objective of this bill. In general, the plan of the section is to make the analysis of adjustment potential more systematic and meaningful, through a formal analysis conducted contemporaneously with the ITC's injury investigation. This approach also makes it more likely import relief will be granted where the domestic industry explicitly commits itself to a workable adjustment plan, mainly through reduced Presidential discretion in such cases. The purpose of developing a plan with Administration participation is to make it more likely the industry will receive relief when the case comes before the President.

Under the section, within 120 days of commencement of the ITC's investigation, an assessment of the industry's current problems and a strategy to enhance competitiveness must be developed in all escape clause cases by a group consisting of representatives of firms and workers in the industry, as well as the U.S. Trade Representative (USTR), the Secretaries of Labor and Commerce, and such other agency heads as USTR designates.

This group would submit its assessment and strategy to the petitioner and to the ITC. In the event the ITC finds the domestic industry is seriously injured or is threatened with serious injury by imports, then the petitioner would be required to submit an industry-wide adjustment plan to the ITC. The petitioner would not be required to submit the plan developed by the group. If the case was government initiated, members of the industry would also be allowed to submit plans.

Once the plan is submitted, the ITC is required to attempt to obtain on a confidential basis commitments from the individual members of the domestic industry concerned on how they will implement the adjustment plan, which are to be transmitted to the President. These commitments are factored into the decision of what import relief or other actions to recommend. They also serve as a basis for monitoring domestic industry actions in the future, if the President does give the domestic industry import relief.

Section 204: Report and Recommendations of the ITC.--This section changes the standard now used by the ITC in recommending action to the President in those cases where an industry is eligible for import relief, that is, in those cases where the ITC has found serious injury to the domestic industry from increasing imports or the threat of such injury.

Under this change, the ITC would determine the import relief (by itself or in combination with other actions, such as trade adjustment assistance, antitrust exemption, or other actions within the power of the President) that creates a reasonable expectation that the domestic industry can compete successfully with the foreign producer after the expiration of the import relief. The ITC cannot recommend more relief than is needed to "prevent or remedy" (the GATT standard for the remedy) the serious injury to the domestic industry. The purpose of the new standard is to change the focus of the escape clause from import protection to positive adjustment, and to increase the likelihood ITC escape clause recommendations will be accepted by the President.

In the event the ITC finds that the industry would be no more competitive after section 201 relief, then the ITC must recommend the actions, including import relief, necessary to provide for the orderly transfer of resources to other productive purposes.

In its report to the President the ITC is to estimate the short- and long-term effects of any additional tariffs or quotas on private and industrial consumers.

Section 205: Presidential Action in Escape Clause Cases.--Under this section, there are two classes of escape clause cases, those in which the ITC determines by a majority vote that the domestic industry was seriously injured or was threatened with serious injury, and those cases in which the ITC made that determination unanimously (cases in which the ITC determination on injury was negative are terminated as under current law).

Unanimous ITC.--If the ITC injury determination is unanimous, then the President must follow the ITC recommendations on remedy. He cannot change the ITC remedy recommendaton unless Congress approves his alternative (on the legislative "fast-track").

Majority ITC.--In cases where the ITC finds injury by a majority, but not unanimous vote, if the President determines that import relief can lead to a domestic industry that can compete without further relief after the expiration of the import relief or other action the President proclaims or orders, then he must grant some form of import relief unless he determines this will endanger national security or would cause serious injury to another domestic industry. This is intended to focus the President on adjustment, give more respect to ITC recommendations, and give firms and workers who petition for relief an assurance that the President will focus on the merits of their problem, not other national economic concerns. If the President determines that the industry can never be competitive, then he must take action to assure the orderly transfer of resources to productive pursuits (unless such action would endanger the national security or injure another industry). In any case where the President rejects the ITC recommendations, Congress may impose the ITC recommendation by enacting a joint resolution, as under current law.

The bill would also give the President a broader menu of actions other than import relief that he could take, to enable an industry to compete, including providing trade adjustment assistance, antitrust exemptions, directing the initiation of antidumping or countervailing duty actions, entering into multilateral negotiations or proposing legislation. Such actions may also be used instead of import relief "to provide for the orderly transfer of the resources of the domestic industry to other productive pursuits." Among the factors the President considers in granting these non-protection actions, are those already provided for in current law and one concerning the efforts of firms in the industry to provide retraining to workers, which is intended to encourage industry to retrain workers rather than firing them under import pressure.

Section 206: Administration, Review, and Termination of Action by the President.--This section restates existing law except for the following changes:

(1) Monitoring adjustment.--The section includes a monitoring procedure, whereby the President's actions can be changed over time. If USTR determines after consultation with the domestic industry that the firms and workers in the industry are not implementing the adjustment plan in a satisfactory manner, then he may recommend to the President that the President terminate or modify the import relief.

(2) Time for relief.--Under this provision, import relief may not last longer than 13 years, as distinguished from eight years under current law. Unlike current law, once that period has expired, the industry is not eligible for import relief again for at least 10 years. The purpose of this provision is to assure the President has adequate time to help the

industry, but also to assure the industry has a strong incentive to improve its competitiveness during any period of import protection. Import relief of more than three years' duration must be gradually phased down, as under current law.

If antidumping or countervailing duty cases are ordered by the President in the course of escape clause proceedings, the ITC is assumed to have made affirmative injury determinations for purposes of those cases, and the statutory time limits for those cases are reduced accordingly.

(3) Evaluation of Import Relief.--This section requires that the ITC, following the termination of any relief provided under the escape clause, evaluate the effectiveness of the relief, hold public hearings, and issue a report to the President and the Congress within six months.

Section 202: Effective Date.--The amendments made under this Title would be effective for cases initiated after enactment of this Act.

Subtitle B: Trade Competitiveness Assistance

This subtitle of the bill changes the emphasis of the existing trade adjustment assistance program from income support for workers and loans for firms to enhancing worker competitiveness through retraining supplied mainly by employers and technical assistance to firms supplied mainly by private contractors, and retitles the program "Trade Competitiveness Assistance."

Section 211: Eligibility of Workers and Firms.--This section would amend the existing criteria for trade adjustment assistance. Subsection (a) makes two changes in these criteria for workers eligibility. First, workers in agricultural firms are made eligible for relief, and second, workers in firms that are indirectly affected by imports -- so-called "secondary" firms which provide essential parts or essential services to the firms directly affected by imports -- are made eligible for benefits. Subsection (b) extends eligibility to firms that meet these new criteria.

Section 212: Cash Assistance for Workers.--This section amends existing law that qualifies workers for trade adjustment assistance benefits if they are unemployed by reason for imports. Under the change, a new requirement of qualifying of benefits would be that the eligible worker is enrolled in an approved training program or has completed such a program after he was separated from his trade-impacted employment. It would also explicitly provide that if the worker fails to begin participation in the training program, then he may not receive a cash benefit. Section (c) allows the Secretary of Labor to waive this requirement where the training is not available or appropriate. Maximum cash benefits to workers would be extended from 52 to 78 weeks (less any amounts paid under standard unemployment insurance).

Section 213: Training Entitlement for Workers.--This provision requires the Secretary of Labor to provide to every eligible and qualified worker directly or through a voucher not more than $4,000 for each import-related separation from work.

Section 214: Sunset.--This section ends the worker program at the end of fiscal year 1991.

Sections 215 through 217: Funding.--These sections establish a trade competitiveness assistance trust fund to pay for the cost of the new program funded by an across-the-board import duty of not more than one percent ad valorem, and authority to negotiate a multilateral agreement permitting such fees for adjustment assistance purposes. The new program does not take effect until such an agreement is reached or three years, whichever is earlier.

TITLE III: UNFAIR INTERNATIONAL TRADE PRACTICES INVESTIGATIONS

Subtitle A: Mandatory Enforcement of United States Rights Under International Trade Agreements

Section 301: Amendments to the National Trade Estimate.--This section requires the USTR to expand the annual National Trade Estimate, a survey of foreign trade barriers and distortions required under the Trade Act of 1984, to include USTR's estimate of the value of additional U.S. goods, services, and investment that could be exported but for the identified foreign barriers and distortion.

Section 302: Actions in Response to Adversarial Trade.--Under this provision, a new requirement would be levied upon the President to reduce unfair trade barriers in countries that practice "adversarial trade." Under this section, the President is required to initiate negotiations to eliminate the trade barriers identified in the National Trade Estimate in countries that show a consistent pattern of market distorting trade practices, including Japan. It has no automatic sanction if the foreign government refuses to eliminate such practices. The President is to report to Congress by December 31, 1988 on agreements eliminating the foreign practice, including evidence of an increase in U.S. exports commensurate with the elimination of the barriers. If foreign governments do agree with the

President to eliminate such barriers and then fail to do so, the President would be required to take action under sections 304 and 305 of this subtitle.

Section 303: Mandatory Initiation of Certain Investigations by the USTR.--Under this section, the provisions in existing section 301 of the Trade Act of 1974 would be amended to provide a special three-step "Response to the National Trade Estimate." The purpose of this section is to put foreign governments on notice that the United States will initiate formal investigations of their barriers to, and distortions, of trade that burden or restrict U.S. commerce to a significant degree.

Step one is for USTR to identify, no later than 45 days after the National Trade Estimate is published, which acts, policies, and practices listed constitute a "significant" barrier to or distortion of U.S. trade ("significant" is defined as foreign barriers or distortions that, if eliminated, would either directly increase U.S. exports significantly or would do so indirectly, by setting an important precedent).

Step two is for USTR to designate which "significant" barriers and distortions are "unjustifiable," which is defined in current law as any foreign "act, policy or practice which is in violation of, or inconsistent with, the international legal rights of the United States." He must also at this stage determine whether the remaining significant foreign barriers and distortions are likely to be within the scope of section 301, even though they are not "unjustifiable."

Step three is that USTR is required to self-initiate formal investigations of all significant "unjustifiable" cases and also of those foreign barriers and distortions otherwise actionable under section 301 that are likely to result in the greatest expansion of U.S. exports, after consulting with U.S. industry. The basis for requiring initiation of formal section 301 investigations in cases of violations of U.S. international legal rights is mainly enforcement of existing agreements, including section 301 settlements.

Section 304: Actions in Response to Investigations under Section 301.--This provision requires the President to retaliate in all section 301 investigations within nine months of a favorable GATT ruling and not less than 15 months after filing or self-initiation, subject to the following exceptions:

(a) A GATT ruling against the United States;

(b) An industry-approved settlement of the matter that offsets or eliminates the foreign barrier or distortion;

(c) A Presidential decision to extend the deadline for 60 days (two extensions are available, provided he certifies to the Congress that resolution appears imminent);

(d) A Presidential decision to terminate the case, even though he agrees the foreign barrier or distortion falls within the scope of section 301, provided he certifies to Congress that satisfactory resolution appears impossible and retaliation would harm "the national economic interest." (This last condition is not available in final, affirmative determinations in section 301 cases against "unjustifiable" foreign trade barriers and distortions.)

This section also requires automatic termination of any retaliatory measure after seven years unless the petitioner objects. If the petitioner wants retaliation continued, the USTR could substitute a new measure to increase the pressure or to relieve the consumer impact of the old measure. The President is also authorized to terminate or modify the retaliation (and, if necessary, provide compensation) if (a) the GATT subsequently finds it to have been a violation of U.S. obligations; or (b) the foreign practice is subsequently eliminated or reduced to the industry's satisfaction.

Section 305: Miscellaneous Amendments.--This section contains provisions adding certain specific bases for action under section 301 developed in Committee hearings over the last two years. These include: (1) Third country effects of unfair practices.--The bill specifically defines "burden on U.S. trade and commerce" as including effects on third markets, displacing U.S. exports to third markets, and import protection that causes diversion of the exports of another foreign country to the United States. Under current law, unjustifiable and unreasonable foreign trade practices must burden or restrict U.S. commerce in order to be actionable under section 301.

(2) Withdrawal of Generalized System of Preferences (GSP) benefits.--This provision would allow the President to retaliate for foreign unfair practices by withdrawing zero duty trade benefits for developing countires under the GSP.

(3) Export "targeting".--Export targeting is included as an "unreasonable" practice actionable under section 301 ("unreasonable" practices are defined in current law as those "which, while not necessarily in violation of or inconsistent with the international legal rights of the United States, are otherwise deemed to be unfair and inequitable"). "Export targeting" is defined in the bill as "any government plan or scheme consisting of a combination of coordinated actions, whether carried out severally or jointly, that bestow benefits on

a specific enterprise, industry, or group the effect of which is to assist the enterprise, industry, or group to become more competitive in the export of a class or kind of merchandise." The bill contains a list of six examples of targeting, including promotion or tolerance of cartels, restrictions on technology transfer imposed for reasons of commercial advantage and the use of export performance requirements.

(4) State trading.--This bill adds to the definition of unjustifiable trade practices under section 301 trading by a state-owned enterprise on other than commercial terms.

(5) Unfair Trade Concessions Requirements.--This bill adds a definition of "denying benefits" to the United States (under current law, "unreasonable" trade practices are those that "deny benefits" to the United States under trade agreements) as including nullification and impairment of the objectives of a trade agreement and "unfair trade concessions requirements," which are foreign government requirements that U.S. firms make some special concessions, such as licensing technology or building a foreign plant, in order to be permitted to export to a foreign country.

Section 306: Compensation Authority.--This section authorizes the President to compensate foreign governments entitled to such compensation under international law by reason of actions taken under section 301.

Subtitle B: Improving Antidumping and Countervailing Duty Enforcement

This subtitle contains five changes to existing U.S. laws that implement U.S. obligations under the 1979 antidumping and countervailing duty trade agreements.

Section 311: Critical Circumstances Reform.--When a subsidy or dumping petition is filed, foreign producers often increase shipments immediately after the filing in order to have their products arrive before penalty duties are assessed. Current law and international agreements provide a deterrent for this situation through retroactive assessment of duties when the Department of Commerce finds "critical circumstances." This provision is intended to implement the original intent of the law and international agreements.

Section 312: Sham Transactions.--This provision requires the Department of Commerce to penetrate a "sham transaction," that is, a transaction where the Department determines that a foreign manufacturer sets up a wholly-owned subsidiary that is not a normal channel of trade in order to absorb antidumping duties, thereby avoiding an increase in price to the final U.S. purchaser. In such cases, the provision requires the Customs Service to treat the final U.S. purchaser as the importer of record, solely liable for the payment of dumping duties.

Section 313: Injury in Fungible Products Cases.--This provision would bar the ITC from making a finding of "no-injury" solely on any of the following bases in cases on: "Fungible" products -- products sold by weight or volume without significant product differentiation in such merchandise whether produced by foreign or domestic producers; the first sales at low prices did not come from importers; low prices first occurred in another comparable market that has a relationship to the U.S. market; U.S. producers are profitable; or, U.S. producers import.

Section 314: Diversionary Dumping.--This provision requires the Department of Commerce to include the impact of the dumping of imports when determining dumping margins on products incorporating such imports to the extent, and only to the extent, that their price is lower by reason of their including materials or components that are the subject of either (a) an antidumping order in the United States, or (b) an arrangement settling pre-existing antidumping cases.

Section 315: Non-Market Economy Dumping.--This provision amends the standard for determining whether a non-market economy country is dumping. It makes the most probable surrogate price, the average price at which similar or the same merchandise is imported from the market economy that accounts for the largest share of U.S. imports.

Section 316: Downstream Product Monitoring.--This section provides for the monitoring of imported products that incorporate materials that have previously been found by the Department of Commerce either to have been dumped in the U.S. markets or subsidized. Based on information received in monitoring reports prepared by the ITC, the Department of Commerce may initiate antidumping or countervailing cases on such "downstream" products.

TITLE IV: INTELLECTUAL PROPERTY RIGHTS

Subtitle A: Intellectual Property Protection

Section 401: Remedies Under the Tariff Act of 1930.--Section 337 of the Tariff Act of 1930 makes unlawful unfair trade practices in the importation of goods into the United States, and for years the ITC, which administers the law, has held -- with support from the courts of the United States, most Administrations and even the GATT -- that the provision allows the ITC to exclude an article from importation into the United States if the imported article infringes a valid U.S. patent, copyright, trademark, or maskwork. However, current law requires a petitioner to show that an efficiently and economically operated domestic industry has been substantially injured by the infringing import. This section eliminates the requirement that the petitioner has to show injury in patent infringement cases, although the petitioner in a section 337 action still has to show that the industry is operating in the United States.

Subtitle B: Access to Technology

Sections 402 through 406: Access to Technology.--Under this section, the President is authorized to enter into negotiations to assure equity of access to technology. It also requires the USTR, in coordination with the National Science Foundation, to monitor technology transfers between the United States and other countries, and it provides that making technology transfer a condition of importation is actionable under section 301 of the Trade Act of 1974. Finally, it requires the Secretary of Commerce to task the Foreign Commercial Service with monitoring and reporting on intellectual property systems abroad and authorizes the President to provide intellectual property protection technical assistance as part of foreign aid.

TITLE V: NATIONAL SECURITY

Section 501: Imports that Threaten National Security.--This provision places a 90-day time limit on Presidential action in cases under section 232 of the Trade Expansion Act of 1962. It also requires the President to make written statements for his actions in such cases.

TITLE VI: UNITED STATES TRADE POLICYMAKING

Section 601: Trade Impact Statements.--This provision requires department heads to make "trade impact statements" for each of their major actions. The purpose is to make trade considerations a major element of agency decisionmaking.

Section 602: National Trade Council.--This provision creates a National Trade Council in the White House, chaired by the USTR to coordinate advice to the President on trade matters.

Section 603: National Trade Data Bank.--This provision is intended to assure the United States develops, over the next several years, adequate data information procedures and resources to provide the necessary backup to the effort that will be necessary in trade policymaking in the United States in the 1990's. Under the provision, an interagency committee establishes a system, and monitors and reports to Congress annually on objectives for, the collection and distribution of data relating to trade.

TITLE VII: AGRICULTURAL TRADE

Section 701: Crisis in Agricultural Trade.--This section describes the growing crisis in U.S. agircultural trade. It states that the policy of the United States is to increase agricultural exports and support programs to make U.S. commodities and agricultural products more competitive. It further states that it is the policy of the United States to reduce expensive agricultural programs consistent with efforts to reduce the Federal deficit, but indicates that the United States will not reduce price support and export subsidies unilaterally to the disadvantage of American farmers and agricultural exporters.

Section 702: Commodities for Cooperator Organizations.--This section would permit the Commodity Credit Corporation to provide surplus commodities to cooperator organizations. Currently, the U.S. Department of Agriculture (USDA) assumes approximately one-third of the costs of cooperator programs to develop foreign markets.

Section 703: Foreign Agricultural Service (FAS) Personnel.--This section ensures an FAS staff of 850, including agricultural attaches posted abroad. FAS is the primary organization responsible for promoting U.S. agricultural exports abroad and developing U.S. markets overseas.

Upon returning from tours of duty overseas, U.S. agricultural attaches will be required to spend the first six months in the United States in agricultural regions. Attaches will use time to counsel farmers on methods to improve exports and on developing markets abroad. The bill also requires attaches to spend at least 60 percent of time on market development and product promotion.

Section 704: Contracting Authority to Expand Agricultural Export Promotion.--This section grants the USDA authority to hire foreign nationals to assist our agricultural attaches abroad.

Section 705: Office of International Market Development and Export Promotion.--The office created by this provision is charged with developing new strategies for creating markets for U.S. agricultural exports and for coordinating all such policies. The office will also monitor the practices of foreign nations in promoting exports. The office will provide an annual report to Congress with recommendations for new promotional policies and assessment of current policies. Other new programs to be implemented by the office include a marketing-export promotion exchange program, a grain quality monitoring office, and a program evaluation unit.

Section 706: New Market Development.--Markets and New Products.--Currently, more than one-half of all U.S. agricultural promotional funds are spent in comfortable, established markets in Europe and Japan. Only nine percent of such funds are spent in Latin America and Africa -- newly emerging agricultural markets. The bill requires one-half of new funds to be used to promote U.S. agricultural exports in developing markets. The bill also requires that one-half of funds be used to promote processed agricultural exports, rather than raw commodities. (See section 719.) The United States is losing its competitive edge in raw exports, but there are valuable markets to be established for processed products. The bill moves U.S. agriculture in that direction.

Section 707: Trade Shows and Exhibitions.--The United States spends approximately one-third of the amount spent by Australia and Argentina per $1 billion in exports on agricultural trade shows and exhibitions. The bill would provide new funds to double the number of trade shows USDA sponsors. The current trade show budget of $2.3 million will be increased to $8 million.

Section 708: Program Management and Support.--This section increases USDA's current authorization for program management and support activities of the FAS from $7.47 million to $10.97 million.

Section 709: Market Promotion and Trade Development.--The section increases from $22.5 million to $30 million the funds for FAS attaches and support personnel in the United States. It requires one-half of new funds to be used to promote exports in developing markets.

Section 710: Export Market Development Advisory Committee: The committee created under this provision will advise USDA on how to improve export promotion and market develoment efforts.

The CHAIRMAN. This hearing will come to order.

We will try to start these hearings on time, and I note that the clock shows that we are starting ahead of time, but they tell me they have a new clock, and it is just 10.

Let me say to the witnesses that we have had fewer witnesses in these hearings than have appeared in similar hearings in the past, but we have tried to have people whom we thought could have a constructive and major contribution to this committee. We want to give them more time to try to develop their points of view, and in turn give the members of the committee more time to question them.

There are a few major companies in this country that I think really stand out in the way of being heavyweights, not just in the volume of their business but in their productivity, their creativity, their innovativeness, and their marketing, and they have chief executives that go with that calibre. I think we have two of those companies here this morning.

One of those witnesses will be Mr. Colby Chandler, who is Chairman of the Board and Chief Executive Officer of Eastman Kodak. He is also Chairman of the President's Export Council, and he is from Rochester, New York.

The other is Mr. Robert Galvin, Chairman of the Board of Motorola. He is from Illinois, and we are very pleased to have him this morning.

I would welcome you. I have no statement, but if you have statements you would like to make, it is all right.

Senator Moynihan, do you have any comments?

Senator MOYNIHAN. I have no statement, Mr. Chairman.

The CHAIRMAN. Mr. Chandler, if you would, proceed please.

STATEMENT OF COLBY H. CHANDLER, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, EASTMAN KODAK, INC.; AND CHAIRMAN, PRESIDENT'S EXPORT COUNCIL; ROCHESTER, NY

Mr. CHANDLER. Thank you, Mr. Chairman. It is a pleasure to be here, and thank you for that privilege. I will keep my comments to my script at the beginning, before questions, in order that we may move swiftly.

The U.S. faces a trade and international financial crisis of unprecedented proportions, I believe you will all agree. In a few short years, we have gone from running a virtual balance in our current account to a deficit of roughly $150 billion, and have gone from a provider of capital to the rest of the world to the largest debtor. And the U.S. manufacturing sector, once considered preeminent, is now under literally under siege. Unless appropriate policy actions are taken soon, we face a grim future of substantially lower standards of living, higher inflation, and slow growth in order to "pay our way" and redress the imbalances that currently exist.

This unhappy vision is not inevitable, however. Much will depend upon the policies adopted by the Congress and the Administration in the months ahead. To a businessperson who depends on open markets and a sound global economy, it seems clear that there are constructive ways to deal with our problems as well as destructive ways. Which path we take depends upon properly identifying the fundamental causes of our problems. Treating symptoms, I believe, will only exacerbate our troubles in the long run. Above all, we need to avoid what may be politically attractive short-term solutions. It is very easy for us to blame others for our problems and devise policies accordingly, but that will not lead to an expansion of world trade or necessarily a reduction in the trade deficit.

The major causes of our trade deficit and our lack of competitiveness can be found in I believe three broad categories: First is the macro-economic policies; second, the fact that much of the rest of the world has, in a very short period, caught up with the United States in terms of technology and manufacturing and marketing capabilities; and the third is the debt burden of the developing countries.

Accordingly, I believe that the principal solutions to our trade problems lie with the following:

First, a substantial reduction in the budget deficit;

Second, further significant dollar depreciation; and

Third, a resolution of the debt crisis in the LDC's.

I would like to discuss these three factors in some detail, and then I will turn to the policy implications.

First, on macro-economic policy: In the United States and abroad, we surely cannot restore our trade balance and American competitiveness unless we make significant headway in reducing that federal budget deficit. I believe all other actions pale in comparison.

Economists tell us that a nation's trade balance is just equal to the difference between its national savings and its investment, and our national savings have never been lower in the post-war period than they have become in this period of massive federal budget deficits.

Our experience since 1981 shows clearly the dilemma: to maintain adequate investment levels in this country, we have had to run unprecedented trade and current account deficits. Thus, absent substantial reductions in the budget deficit, to reduce our trade deficit we must first cut investment, which robs us of the means to pay our way in the future, or second, figure out a way to increase savings, which probably is unlikely.

The other side of the macro equation is interest rates. If substantial strides are taken on the budget deficit, interest rates will need to come down. Budget deficit reduction without lower interest rates could send the U.S. and global economies into a serious downturn. Since growth has been driven in large measure by fiscal expenditures, any significant contraction there would need to be offset by interest rate reductions in order to maintain a healthy economy. Clearly, the last thing we can afford is a global recession. If our trade problems and the debt servicing difficulties of our farmers, corporations, and developing countries look daunting now, these conditions will clearly be exacerbated in a recessionary environment.

If, on the other hand, deficit reduction were offset by lower interest rates, the benefits to U.S. manufacturers, the domestic economy and the global economy would be many. First, the dollar would fall further. And as I indicated at the outset, I believe the fundamentals will drive further dollar depreciation in the 20 to 30 percent range. The depreciation to date has been helpful, but we need much more, and here is why:

The Japanese worker in manufacturing today makes roughly 60 percent of his American counterpart. Korean and Taiwanese workers make 11 percent of what the average American worker makes. At the same time, manufacturing productivity in Japan has increased 60 percent in the eight years since 1977, compared to only 22 percent in the United States. Even more striking are the gains in Korea, where manufacturing productivity has grown at an average of 12 percent a year over the last 15 years.

Given the disparity in wages and productivity growth, it is simply not possible to envision a substantial increase in our competitiveness that does not involve further decline in the value of the dollar. U.S. made goods would simply not be competitive. A much lower dollar is not without costs in terms of real wages and inflation. However, the alternative seems worse: more erosion in our competitive position, and increasing resort by U.S. manufacturers to production abroad in countries where labor costs are lower.

Lowering of interest rates here would inevitably force our major trading partners, Germany and Japan, to do likewise. If nothing else, they would have to act to try to keep their exports competitive. Lower interest rates abroad, which the Administration has been advocating with little success, would stimulate global economic growth—a desirable effect, since one reason our trade deficit remains so large is because growth in the rest of the industrial world is so anemic.

For example, the German economy is expected to grow by only 2 percent. If that key economy of Western Europe does not grow, the rest of Europe will not grow. Japan is barely growing. Without reasonable growth in the second and third largest industrial economies, it is hard to see how we can reduce our trade deficit in a constructive manner.

A second basic problem exists in the fact that the rest of the world has essentially caught up with and in some areas surpassed the United States in technology. Remarkable advances have been made in the past 10 years which exceed the progress of the previous 50 years. The pace of change, the dissemination of information, know-how, and so forth, is phenomenal today. Clearly, there is no room for American industry to be complacent any longer.

We must be prepared to face this reality head on. Complaining about the way other countries do business will not solve our problems. We cannot remake the world in our image and force governments to pursue policies compatible with ours. The enormous task before us is to devise policies which maximize our ability to compete in this new world, not policies which isolate or insulate us from it.

I know, for Eastman Kodak Company, that our biggest challenge is the competition. Ten years ago that would not have been the case; but large strides have been made by our competitors, and I think it is safe to say that a healthy respect for that fact has done much to prompt enormous change in our company. In the three years 1985 to 1987, Kodak will have invested nearly $5 billion in capital improvements to make our operations more efficient, and about $3 billion in research and development.

Thirdly, we must resolve the developing country debt crisis if the trade deficit is to be reduced. To pay our way, we need robust and sustained growth in the developing world. They are large customers of the U.S. manufacturers.

Latin America in the 1970's was a growing market. We need to stimulate that market as a consumer of goods and services provided by U.S. suppliers.

The U.S. trade balance with the 20 Latin American republics shifted from a $5.5 billion annual surplus in 1981 to an annual rate deficit of $15.5 billion in 1986, a net change of $21 billion. Over half of this worsening trade balance was due to a fall in U.S. exports, a situation unique among the major regions that account for the bulk of U.S. trade. This is a direct result of the policy response of Latin American governments to the debt crisis.

Moreover, adjustment policies imposed to deal with the debt problem may be reducing Latin America's future economic growth potential, as well as limiting the market for U.S. goods. Between 1983 and 1985, investments as a percentage of Gross Domestic Product fell by one-fourth compared to the previous five years. This decline in investment is almost identical to the increase in external surpluses being run by these countries in order to service their debt. In other words, today's interest is being paid at the expense of tomorrow's growth.

Balancing competing interests to assure an equitable and successful resolution of the debt crisis is extremely complex and difficult. What does seem clear, however, is that current policies are not achieving desired results.

Well, I have cited the crucial need to alter macro-economic policy, the enormous increase in competition, and the debt problem of the Third World as the tree most critical problems relating to trade. The key question is: How should this committee respond, given these challenges?

To begin with, I believe the overriding imperative for policymakers in the Congress and the Administration is to work together to devise a realistic program of budget deficit reduction. We cannot afford to leave this problem unresolved. We are in the fifth year of a recovery. Sooner or later we are going to face a recession. As a businessman whose company's success depends on consumer demand, I would hate to see us have to cut the budget deficit during poor economic conditions.

Action by the Congress to reduce the federal budget deficit would not only free the Federal Reserve's hand to lower interest rates, but it would most likely trigger a similar response by Germany and Japan. A realistic, politically-viable deficit-reduction program would be compelling evidence to the world that, indeed, the U.S. was coming to grips with its problems.

A worldwide cut in interest rates would reduce the cost of capital for investment. A further benefit is that lower interest rates help reduce the budget deficit in a painless way.

I recognize that the developing-country debt crisis does not lend itself readily to legislative solutions. However, I would offer a couple of thoughts on this problem:

First, restricting access to the U.S. market for goods from heavily-indebted Third World nations, while pushing them to accept more imports from the U.S. and at the same time expecting them to service their debt as currently structured, is asking a great deal.

Second, it seems to me that we have to make some choices on how we want to handle this problem. Certainly it is my view that the interests of the United States manufacturing sector have not been adequately taken into account.

We also need to consider the critical question of how we respond to the rest of the world catching up with us. Clearly, there are two important things that can be done:

First, I would urge that we give the Administration the authority to negotiate tariff and non-tariff barrier reductions in the new GATT round. In a world where the U.S. is no longer preeminent it is vitally important to revitalize the multilateral system. Twenty years ago we could write the rule of the global economy, and we could walk away from them when they were not in our interests, but no longer. Today, more than ever, we need a system of multilateral checks and balances if U.S. trade interests are to be preserved.

Our best hope, and perhaps our only hope, to get beyond the trade impasse is through negotiated agreements with our trading partners. We need existing rules strengthened, and we need expanded coverage for services, investment, subsidies, intellectual property. These are today's and tomorrow's problems.

Second, we need to be careful about protectionist solutions. Of course, the easiest thing this committee can do is legislate import restrictions—it is straightforward. However, it is very hard to see how restricting our markets will increase the competitiveness of U.S. industry. A tariff on imports will harm U.S. exports.

There are, of course, sectoral problems of excess capacity, of uncompetitiveness; but there are also costs, often hidden, to government intervention. Managing trade in one sector will inevitably reduce competitiveness in another, because restricted trade raises prices, and higher prices hurt users and ultimately hurt producers.

Well, I have discussed at some length what I consider the problems to be and what might be usefully done. I would like to conclude by saying that, clearly, I place primary responsibility for maintaining competitiveness on the shoulders of American business. Government has, at the same time, an obligation to provide a reasonable economic environment of steady growth, a fairly valued currency, and low inflation. Government must also be sensitive to the problems which excessive regulation can cause.

Ultimately, however, business must take the hard steps—and I believe it is—to make itself competitive. We and our shareowners need to think long-term instead of short-term. We need first class research and the means to apply that research to commercially-viable products in a timely fashion. And we need to think globally and be prepared to tailor our products to local markets.

I believe we are doing that at our company, Eastman Kodak, and at many other companies, where the need to become more competitive is driving enormous change in this country. And although I have every confidence in American business, I do not underestimate the seriousness of this task.

Thank you.

The CHAIRMAN. Thank you very much, Mr. Chandler.

The next witness I want to call on is an old friend of many years, a man who has had an extraordinary career in business and a deep interest in trade, Mr. Robert Galvin of Motorola.

[Mr. Chandler's prepared written statement follows:]

SENATE FINANCE COMMITTEE TESTIMONY

by Colby H. Chandler
February 5, 1987

The U.S. faces a trade and international financial crisis of unprecedented proportions. In a few short years, we have gone from running a virtual balance in our current account to a deficit of roughly $150 billion From a provider of capital to the rest of the world we have become the largest debtor. And the U.S. manufacturing sector, once considered preeminent, is now under siege. Unless appropriate policy actions are taken soon, we face a grim future of substantially lower standards of living, higher inflation and slow growth in order to "pay our way" and redress the imbalances that currently exist.

This unhappy vision is not inevitable, however. Much will depend on the policies adopted by the Congress and the Administration in the months ahead. To a businessman who depends on open markets and a sound global economy, it seems clear that there are constructive ways to deal with our problems, and destructive. Which path we take depends on properly identifying the fundamental causes of our problems. Treating symptoms will only exacerbate our troubles in the long run. Above all, we need to avoid politically attractive, short term solutions. Its very easy to blame others for our problems and devise policies accordingly. But that will not lead to an expansion of world trade or a reduction in the trade deficit.

The major causes of our trade deficit and our lack of competitiveness can be found in three broad categories. The first is macro economic policy. The second is the fact that much of the rest of the world has, in a very short period, "caught up" with the United States in terms of technology, manufacturing and marketing capabilities. The third is the debt burden of the developing countries.

Accordingly, I believe that the principal solutions to our trade problems lie with the following:

1) substantial reduction in the budget deficit,
2) further significant dollar depreciation, even if it means a bit more inflation; and
3) a new approach to the debt service problem in heavily indebted Third World nations.

I would like to discuss these three factors in more detail. After which, I will turn to the policy implications for the Senate Finance Committee as it begins formulating its trade and competitiveness legislation in the weeks and months ahead.

--3

First, the critical question of the conduct of macro economic policy, both in the United States and abroad. There can be no substantial improvement in our trade balance and restoration of American competitiveness unless we make significant headway in reducing our federal budget deficit. All other actions pale in comparison.

Economists tell us that a nation's trade balance is just equal to the difference between its national savings and investment. And our national savings have never been lower in the post-war period than they have become in this period of massive federal budget deficits.

Our experience since 1981 when the budget deficit began to mushroom shows clearly the dilemma: to maintain adequate investment levels in this country, we have had to run unprecedented trade and current account deficits. Thus, absent substantial reductions in the budget deficit, to reduce our trade deficit we must (1) cut investment, which robs us of the means to pay our way in the future, or (2) figure out a way to increase savings, which is unlikely.

--4

The other side of the macro equation is interest rates. If substantial strides were taken on the budget deficit, interest rates in the U.S. would need to come down. Budget deficit reduction without lower interest rates could send the U.S. and global economies into a serious downturn. Since growth has been driven, in large measure, by fiscal expenditures, any significant contraction there would need to be offset by interest rate reductions in order to maintain a healthy economy. Clearly, the last thing we can afford is a global recession. If our trade problems and the debt servicing difficulties of our farmers, corporations, and developing countries look daunting now, imagine how threatening they would be in a recessionary environment.

If, on the other hand, deficit reduction were offset by lower interest rates, the benefits to U.S. manufacturers, the domestic economy and the global economy would be many. First, the dollar would fall further. As I indicated at the outset, I believe we need substantial further dollar depreciation, in the 20 to 30 percent range. The depreciation to date has been helpful, but we need much more. Here is why.

--5

The Japanese worker in manufacturing today makes roughly sixty percent of his American counterpart. Korean and Taiwanese workers make 11 percent of what the average American worker makes. At the same time, manufacturing productivity in Japan has increased 60 percent since 1977 compared to only 22 percent in the United States. Even more striking are the gains in Korea where manufacturing productivity has grown at an average of 12% per year over the last 15 years!

Given the disparity in wages and productivity growth, it is simply impossible to envision a substantial increase in our competitiveness that does not involve further decline in the value of the dollar. A much lower dollar is not without costs, in terms of real wages and inflation. However, the alternative seems worse: more erosion in our competitive position and increasing resort by U.S. manufacturers to production abroad in countries where labor costs are lower.

Lowering of interest rates here would inevitably force our major trading partners, Germany and Japan, to do likewise. If nothing else, they would have to act to try to keep their exports competitive. Lower interest rates abroad, which the Administration has been advocating with little success, would stimulate global economic growth, a desirable effect since one reason our trade deficit remains so large is because growth in the rest of the industrial world is so anemic.

For example, the German economy is expected to grow by only 2 per cent. If that key economy of Western Europe does not grow, the rest of Europe will not grow either. Japan is barely growing. Without reasonable growth in the second and third largest industrial economies it is hard to see how we can reduce our trade deficit in a constructive manner.

A second basic problem exists in the fact that the rest of the world has essentially caught up with, and in some areas surpassed the United States in technology. Remarkable advances have been made in the past ten years which exceed the progress of the previous fifty years combined. The pace of change, the dissemination of information, know-how, etc. is phenomenal today. Clearly, there is no room for American industry to be complacent any longer.

We must be prepared to face this reality head-on. Complaining about the way other countries do business will not solve our problems. We cannot remake the world in our image and force governments to pursue policies compatible with ours. The enormous task before us is to devise policies which maximize our ability to compete in this new world, not policies which isolate or insulate us from it.

I know for Eastman Kodak Company that our biggest challenge is the competition. Ten years ago, that would not have been the case. But large strides have been made by our competitors and I think it is safe to say that a healthy respect for that fact has done much to prompt enormous changes in my company. In the three years 1985-1987, Kodak will have invested nearly $5 billion in capital improvements to make our operations more efficient, and about $3 billion in research and development.

Third, we must resolve the developing country debt crisis if the trade deficit is to be reduced. To "pay our way", we need robust and sustained growth in the developing world. Latin America in the 1970's was a growing market. We need to stimulate that market, as a consumer of goods and services provided by U. S. manufacturers.

--8

The U.S. trade balance with the 20 Latin American republics shifted from a $5.5 billion annual surplus in 1981 to an annual rate deficit of $15.5 billion in 1986 -- a net change of $21 billion. Over half of this worsening trade balance was due to a fall in U.S. exports, a situation unique among the major regions that account for the bulk of U.S. trade. This is a direct result of the policy responses of Latin governments to the debt crisis.

Moreover, adjustment policies imposed to deal with the debt problem may be reducing Latin America's future economic growth potential, as well as limiting the market for U.S. goods. Between 1983 and 1985 investments as a percentage of GDP fell by one-fourth compared to the previous five years. This decline in investment is almost identical to the increase in external surpluses being run by these countries in order to service debt repayment. In other words, today's interest is being paid at the expense of tomorrow's growth.

Balancing competing interests to assure an equitable and successful resolution of the debt crisis is extremely complex and difficult. What does seem clear, however, is that current policies are not achieving desired results.

--9

I have cited the crucial need to alter macro economic policy, the enormous increase in competition, and the debt problems of the Third World, as the three most critical problems relating to trade. How should the Finance Committee respond, given these challenges?

To begin with, I believe the overriding imperative for policy-makers in the Congress and the Administration is to work together to devise a realistic program of budget deficit reduction. We cannot afford to leave this problem unresolved. We are in the fifth year of a recovery. Sooner or later, we are going to face recession. As a businessman whose company's profitability depends on robust consumer demand, I would hate to see us have to cut the budget deficit during poor economic conditions.

The Senate Finance Committee is central in any effort to devise a budget deficit reduction plan. I would urge all members of the Committee to work together and with the Administration in a bipartisan manner to deal with this problem.

Action by the Congress to reduce the federal budget deficit would not only free the Federal Reserve's hand to lower interest rates, but would most likely trigger a similar response by Germany and Japan. The Germans, when

71-855 0 - 87 - 6

--10

pressed to alter their economic policies, constantly tell us to "get your own house in order before coming to us". A realistic, politically viable deficit reduction program would be compelling evidence to the world that, indeed, the U.S. was coming to grips with its problems.

A worldwide cut in interest rates would reduce the cost of capital for investment. A further benefit is that lower interest rates help reduce the budget deficit in a painless way.

I recognize that the developing country debt crisis does not lend itself readily to legislative solutions. However, I would offer a couple of thoughts on this critical problem. First, restricting access to the U.S. market for goods from heavily indebted third world nations, while pushing them to accept more imports and at the same time expecting them to service their debt, is unreasonable. As you craft legislation, I urge you to keep that in mind.

Second, it seems to me that we have to make some choices on how we want to handle this problem. Certainly, it is my view that the interests of the U. S. manufacturing sector have not been adequately taken into account.

--11

We also need to consider the critical question of how we respond to the rest of the world catching up with us. Clearly, this is where the bulk of your efforts will be focused. There are two very important things you can do.

First, I would urge you to give the Administration the authority to negotiate tariff and non-tariff barrier reductions in the new GATT round. In a world where the U. S. in no longer preeminent, it is vitally important to revitalize the multilateral system. Twenty years ago we could write the rules for the global economy, and we could walk away from them when they were not in our interest. No longer. Today, more than ever, we need a system of multilateral checks and balances - if U.S. trade interests are to be preserved.

Our current trade policy has been likened to World War I. We are dug into trenches lobbing trade restricting actions at each other, prompting retaliation and counter-retaliation. Clearly, this is a negative sum game.

Our best hope -- perhaps our only hope -- to get beyond the current trade impasse is through negotiated agreements with our trading partners. We need existing rules strengthened and we need expanded coverage for services, investment, subsidies, intellectual property. These are today's and tomorrow's trade problems. We need to agree upon international rules if we are to avoid unilateral protection, a rise in beggar-thy-neighbor policies, and ultimately, a repeat of the disastrous policies of the 1930's.

Second, avoid protectionist solutions. The easiest thing the Senate Finance Committee can do is legislate import restrictions. However, it is very hard to see how restricting our markets will increase the competitiveness of U.S. industry. A tariff on imports can only harm U.S. exports.

As you are debating how to deal with sectoral problems of excess capacity, or uncompetitiveness, remember that there are costs, often hidden, to government intervention. Managing trade in one sector will inevitably reduce competitiveness in another, because restricted trade raises prices, and higher prices hurt users and ultimately, producers.

--13

I have discussed at some length what I consider the problems to be, and what the Senate Finance Committee can most usefully do. I would like to conclude by saying, that I place primary responsibility for maintaining competitiveness on the shoulders of American business. Government has an obligation to provide a reasonable economic environment of steady growth, a fairly valued currency and low inflation. Government must also be sensitive to the problems which excessive regulation can cause.

Ultimately, however, business must take the hard steps to make itself competitive. We need to think long term, instead of short term. We need first-class research and the means to apply that research to commercially viable products in a timely fashion. And, we need to think globally and be prepared to tailor our products to local markets.

We are doing that at Eastman Kodak Company and at many other companies where the need to become more competitive is driving enormous change. Although I have every confidence in American business, let no one underestimate the task ahead of us.

1/26/87

STATEMENT OF ROBERT W. GALVIN, CHAIRMAN OF THE BOARD, MOTOROLA, INC., SCHAUMBURG, IL

Mr. GALVIN. Thank you very much, and thank you for the privilege of appearing before your committee.

In my written testimony I have dealt with the macro-factors and have done so under a series of themes: the themes of neglect, ideology, pervasive change, and time. I leave for the record what has been stated there, and I would be pleased to respond to observations or questions if it were in the interest of the committee to do so.

I would prefer to go to what literally is the second part of my testimony, which I will now summarize in order to provide a specific emphasis and possibly even a point of contrast for the interest of the committee.

Your quest to improve trade performance and competitiveness will span those macro-issues and the major issues like federal deficit, currencies, education, et cetera. They are vital; but none, if acted on, will have notable effect for years. Timeliness is also essential to business success.

Industry trade problems are immediate and particular, so I focus now on one: the excess trade imbalance with Japan and other nations due to inadequate real access to their markets.

Conventional wisdom has been "trade laws are adequate; reciprocity on access is protectionism." The wisdom has sustained. The trade deficit has soared.

Reality may be changing. The Administration may propose reciprocity in some cases of market access denial. This speaker favors a similar theme. Proposals are surfacing to strengthen our trade laws.

I hope this may reflect a principle stated by Jean Kirkpatrick, who recently wrote: "Shielding industries from competition is one thing; insisting that they be permitted to compete is another. The issue is gaining access." That is the critical issue with Japan, as an example.

My company is slowly gaining sales in Japan with some of the more open-minded there, but many steps require the U.S. Government authorities' help to open the next market. Our few government authorities can't be available to open every single door. It is no fun for them or for us that we have to operate in that mode. It is uncompetitively costly to have to promote a market that way. Ironically, I believe that many Japanese leaders who mistakenly view their market as more open than it is mean for it to be more open. But—and here is the critical factor—leaders there, collectively, cannot do anything significant about it; their central organs of government cannot take grand decisions on issues like access and make them stick. Many semi-autonomous groups share power in Japan. They are involved with discretionary rights of self-determination. Some are Ministries, who have different points of view between them; some are political factions, and they have their reserved power; some are industry groups. They cooperate, but they also offset each other. And they don't wish that their arena's plans be affected by too many accommodations to non-traditional associates. The result is an aggregation of protectionism.

Marry this with the appealing culture of avoiding serious conflict in that society. The Japanese way is not to face an issue, to the point of forcing others to subordinate their positions to another. Conflict remains unresolved. Relevance? No consequential change in the myriad of buying restraints will occur by our negotiation or persuasion; only vigorous pressure, with very serious, predictable consequences—if not heated—can give the Japanese the justification to come together and implement access. Some Japanese quietly welcome such pressure to ease the way.

There is only one consequential pressure I know of, and that is the proposal that surfaced here last year. That plan provided for annual surplus-reduction goals for countries deemed to have excess trade surpluses. The President would be required to take action to redress those not met with tariffs or other measures.

I know that suggestion does not satisfy today's conventional wisdom, but yesterday's conventional wisdom has not satisfied our trade deficit. That plan, which did surface here last year, does not deserve the pejorative label "protectionism." Its purpose is to open and free markets. It is the only tool that will work soon to leverage the others to open there.

They will not want to suffer those tariffs, and need not. Frankly, we don't want them to have to take effect. Their prospective application is but a means to an end. If access were actively implemented, America would then shift into gear.

Let me conclude with the essential reason we must achieve this result promptly: American industry cannot compete—I repeat, American industry cannot compete—sufficiently, unless it actually sells large volumes in Japan and other key markets as a competing, disciplining force there. That is the "rules of the game" in business. Otherwise, their whole market is a sanctuary, while we have no and ask no sanctuary here.

If today's conditions persist for just a few years, Japan in particular will continue its unchallenged bid to systematically undermine Western industries, as Peter Drucker puts it. He dubs this "adversarial trade" as distinct from competitive trade. That kind of trade aims at winner-take-all; whereas, the Western and American purpose is pursuit of access and access to all markets in a win-win environment.

Those of us who see this reality today want all of our trading partners to prosper, but in a give-and-take mode which achieves the condition where all of us can actually compete abroad as well as at home.

Thank you.

[Mr. Galvin's prepared written statement follows:]

MOTOROLA INC.

BEFORE THE

U.S. SENATE COMMITTEE ON FINANCE

HEARINGS ON MASTERING THE WORLD ECONOMY

STATEMENT OF

ROBERT W. GALVIN

CHAIRMAN OF THE BOARD

MOTOROLA, INC.

FEBRUARY 5, 1987

[illegible] K Street N.W. Suite [illegible] D.C. 20006 (202) 862-1500

It is a pleasure to appear today before the distinguished members of this Committee. The leadership of the Senate and this Committee demonstrate a strong sense of urgency and seriousness of purpose in examining problems of U.S. competitiveness and international trade and investment. The magnitude of our problems is not yet widely appreciated or understood, so these hearings should play a role in informing the American public and creating a consensus to implement the dramatic and far reaching changes that are required.

My intention is to place on the record certain themes that may provide a framework for your investigations and for designing an appropriate course of action. Certain more particular suggestions are also offered.

The first of these themes is neglect. In the United States, we have simply not faced up to the long term erosion of our economic productivity and of many of our strategic industries. More recently, we have ignored the deleterious impact of immense federal budget and current account deficits and an overvalued dollar. The consequence of these many years of neglect is that the sacrifices required to correct these problems will be much greater than they might otherwise have been. Each year that we debate the issues and argue about what to do only raises the costs that must eventually be borne in our society. Each time we settle for the best we can achieve, given political realities, we only raise the ante. You can't play table stakes poker with only a few chips in front of you. And we are in a competitive poker game in which other countries are willing to put all their chips into the pot. In fact, the United States has as many chips as anyone else and could play the game much more successfully, if we had the will to do so.

My second theme is ideology . We live in a world of ideas and concepts. How often have we heard the phrase perception is reality. The phrase rings true if it determines the way people behave. Each of us can cite examples. But if perceptions become so far removed from reality that the discrepancies cannot be ignored, a crisis occurs and a new set of perceptions will inevitably take their place. In my opinion, the ideology which has determined U. S. perceptions and policies regarding international competition and trade has gotten so far from reality that it must be reconstituted and reinvigorated. We are competing in a world of nations with different ideologies -- from the state development economies of East Asia, to the mixed economies of Europe, to the centrally planned economies. Each of these other ideology practitioners is results oriented, restricting foreign access to their home markets while mobilizing national resources to accomplish national performance objectives in the others' markets. The United States is process oriented, believing that competitive processes always produce the best results If other nations adhered to the same process orientation, our ideology would be workable, but they do not. The consequence is that sooner or later at least some other nations find a way to achieve the results they want -- at our expense. With the growing interdependence of the U. S. economy with the rest of the world, we can no longer ignore the reality that differences in ideology are undermining the ability of our economy and society to maintain its security and its standard of living. We must create a framework that accepts these differences as reality and seeks to preserve our values within that context. If, in pursuing such a framework, we want other nations to behave differently, we will have to take decisive new action to cause their different behavior.

A third theme is pervasive change. After many years of neglect, because we were committed to an ideology inconsistent with world realities, we are in a position that will require pervasive changes. Numerous commissions, associations, committees, and academics have generated very long, detailed and remarkably consistent lists of changes needed to restore U. S. competitiveness and improve the international trading system. What is striking about these lists is their scope and the magnitude of changes proposed. Creating effective incentives for production and achieving more rapid productivity improvement while discouraging consumption will be a wrenching change. Balancing the budget without causing a serious recession is an incredibly difficult task. Eliminating the market distorting practices of other countries and renegotiating the international rules of the game is a formidable challenge. To accomplish such pervasive changes will require the next President to commit at least as high a priority and persistent an effort to restoring full U. S. competitive openings and competence as President Reagan has to rebuilding American defense capabilities and credibility. It will require a clearer determination and a much closer partnership between the President and the Congress.

The final theme is time. To adapt our ideology to world realities and implement the pervasive changes needed to overcome years of neglect will take time -- a long time. Even if the grand changes such as fiscal deficit reduction, currency revaluation, education and training enhancements, etc. could be legislated today it would take years before the effects could filter through our economy and generate the desired results. In the interim, like the oil tanker trying to change direction, the momentum from years of neglect will further erode our ability to recover without likely dislocation in our economy such as further dollar valuation churning, higher interest rates, slowing economic growth and decline in our standard of living. It is a challenge to all of us to devise interim measures that can be taken to minimize such risks without diverting attention from the more fundamental changes that must be systematically implemented over the coming years. We need to prioritize changes to achieve the greatest impact as soon as possible, rather than try to do everything at once.

In addition, we need to reorder our priorities for renegotiating the international rules of the game. Our priorities should focus on creating a framework that will permit the U.S. to co-exist with economies based on different ideologies. Instead of segmenting negotiations based on the fragmented bureaucracies that deal with monetary, fiscal, trade and other dimensions of our economy, we need an integrated approach that recognizes they are pieces of a larger puzzle. And the agenda should reflect as priorities the issues that matter most, not the ones on which we can most easily reach an agreement. To obtain meaningful negotiations on the most critical issues we must first act in a manner that clearly defines and supports virtually each U. S. ndustry and service group's effective reciprocal acce to each key market.

Many of us in the business community who are engaged in global competition have already had to face some hard realities and make dramatic changes in the way we manage our businesses. We now need the same level of effort from all parts of government if these adverse effects on the U.S. national interest are to be reversed.

In the foregoing statement, I have outlined several broad themes for your consideration which relate systematically to U. S. trade. Our competitive problems are so serious that nothing but a systems approach -- a comprehensive strategy on the fiscal deficit, currency stability, education, etc. -- will fundamentally reverse America's trade performance. Others will speak to these subjects usefully I am sure. What I suggest is that none of these, even if enacted today, will have any tangible effect on trade for, at a minimum, five years. You must not be satisfied with that timing. Timeliness is essential to success in business and trade. As time passes with insufficient action, it becomes a question of survival to many.

Our trade problems are so varied that nothing less than a series of particular, interelated solutions will resolve the critical needs of the U.S. manufacturing, agricultural, and service sectors. So I would like to focus on one such issue -- the need for timely action on excessive trade imbalances with Japan and other nations.

Years ago, when U. S. trade performance was not so seriously out of balance, and high technology trade even had a healthy surplus, some of us urged enactments of stronger, more effective provisions in our trade laws and the adoption of a principle of reciprocity to assure access to other nations' markets similar to the access they enjoy in the U. S.

However, the conventional wisdom was: our trade laws were already good enough --- and reciprocity is a synonym for protectionism. The conventional wisdom was sustained. The trade deficit soared.

Time has passed. Too much time has passed. Greater appreciation of the reality is more evident. We are told that the Administration will soon propose for your consideration reciprocity provisions of some kind in cases where countries deny market access. The Speaker of the House favored a similar theme in his response to the State of the Union message. Various proposals are surfacing to strengthen our trade laws. Hopefully, what is ultimately enacted will reflect an acceptance of the principle enunciated by one of our more distinguished diplomats, Jeanne Kirkpatrick, who wrote recently, "Today's realities have escaped the old dichotomies of the free trade vs protectionism debate. Shielding idustries from competition is one thing; insisting that they be <u>permitted to compete</u> is quite another. <u>The issue today</u> is less protecting American industries than <u>gaining access</u> to foreign markets." (emphasis added)

That has been, and is, the critical issue with Japan and some other nations. I suggest that it is as much in Japan's and other high surplus nations' long term interests, as it is ours, that this inherent condition be rectified now before the immoderate results of today convert to intolerable conditions tomorrow. History teaches that intolerable conditions inevitably lead to torturous reactions. None of us want these.

Frankly, my company is slowly gaining sales and investments in Japan with some of the more open-minded there, but many steps along the way have to be accompanied by a "firefighting act" by some U.S. Government authority to help open the next market. Few companies have the resources or the fortitude to make such effort. Our Government can only attend to a few such causes. It's no fun to do business that way and certainly is costly to us and to our customers. Frankly, again, I believe many Japanese leaders who mistakenly view their market as more open than it is also genuinely mean for it to be more open.

But, and here is THE critical factor: Leaders (collectively) there can't do anything significant about it because Japan is not a sovereign state that works like ours. Its central organs of government cannot effectively make certain grand decisions and make them stick -- not on issues such as access. Theirs is a state with many semi-autonomous groups who share power - who are essentially endowed through practice, traditions and culture with their own discretionary rights of self determination. Some groups are governmental such as Ministries. Some are political factions such as farmers. Some are private such as Keiretsu and industries. Sometimes they cooperate. Sometimes they offset one another. They find their most common bond in their general agreement to develop the state.

Most of these semi-autonomous groups have their individual aggressive objectives and don't wish their plans affected by too many accommodations to non-traditional associates. The result: an aggregation of protectionism.

Marry this with the Japanese culture of avoiding serious conflict among groups. Even if one group wanted to change the country's policy, the Japanese way is not to face an issue to the point of forcing one group to subordinate their views to another. Such issues-in-conflict simply remain unresolved. Thus, in Japan no consequential changes in the myriad of buying restraints in virtually all groups have occurred, or will occur, as a result of actions you may take under the so-called systems approach to trade policy or any of the negotiation or persuasion efforts our country has tried to date. Nothing major on this subject can be achieved unless vigorous, consistent, consequential pressure from the outside is exerted. If actively applied this pressure would be inimicable to their country and thus be justification for a consensus to implement access effectively and avoid the pressure. Incidentally, at times some Japanese quietly welcome such pressure as a valid excuse to ease the way to particular change.

I know of only one vigorous, consistent, consequential pressure that can be the convincing motivator to move the Japanese to solve their problem and ours, of access to Japan -- that is a plan such as proposed in last year's trade policy deliberations. That plan provided for annual surplus reduction goals for countries deemed to have excessive trade surpluses with the U.S. If the goals are not met, the President would be required to take necessary action to redress the imbalances, including imposing significant tariffs or other enforcement measures. I am informed that such an idea is supposed to be persona non grata at this time. The conventional wisdom opposes it. I suggest that just as the conventional wisdom of yesterday has been insufficiently supportive of trade, so it will be tomorrow. If we do not understand and respond effectively to the determinative factors, timely correction will not occur.

Reconsideration of that plan does not deserve the pejorative label - "protectionist." Its purpose is to open and free markets. It is the only tool that will do the job soon in Japan and elsewhere as it gives them the only persuasive reasons to effect a fundamental change. Leadership there will choose to buy more and thus sustain the process of selling openly, tariff free. They won't want those tariffs to take effect because they'll hurt. Frankly, we don't want them to have to take effect. Their prospective application is only a means to an end - to provide the Japanese and others a need for and justification for abandoning pervasive purchase restraints. With access actively implemented Americans would shift into gear and the excess bilateral trade balance would rapidly disappear.

Let me conclude with a statement of the primary reason why we must achieve this result promptly. American industry can not compete -- I repeat, American industry can not compete -- sufficiently unless it actually sells large volumes in Japan and the other key markets as a competing force there. Otherwise their home market is a sanctuary to home industry while we have no and ask no sanctuary here. If today's conditions continue for even just a few more years, Japan in particular will continue its unchallenged bid to systematically undermine Western industries as Peter Drucker puts it. He dubs this "adversarial trade" as distinct from competitive trade. That kind of trade aims at winner-take-all whereas the Western and/or American purpose is vigorous pursuit of markets in a win/win environment.

Those of us who see this reality today want all our trading partners to prosper, but in a give and take mode, which achieves the condition where all of us can actually compete abroad as well as at home.

The CHAIRMAN. Thank you very much, Mr. Galvin, and your entire statement will be taken into the record. I have had a chance to read it as we have been seated here, and it makes a major contribution. Obviously, you deal in some controversial issues, and that is good. We need those points of views ably expressed, as you have, in our consideration.

Let me say that the order of questioning will be in the sequence of arrival. It is Moynihan, Packwood, Baucus, Rockefeller, and Bradley. I note that the Chairman was second in the arrival, but he will exercise his prerogatives and question first.

Let me ask you about the size of the Japanese market. You talk about access to it and that that is important, but I would assume that is not just to the Japanese market; you have some of those same barriers in Taiwan and South Korea and some of those same barriers in Europe. Is the size of the market sufficient where it is significant to a company like Motorola?

Mr. GALVIN. The size of the Japanese market and the German market and certain other of the well-developed or now well-developing nations are very significant to American industry and indeed to our corporation that happens to have the privilege of offering modern products to a modern society. And it is absolutely the volume of business that would be meritorious for American industry, for the benefit of creating wealth for the American society to enjoy.

I obviously have made a most particular point, that when one understands the strategic significance of sanctuaries versus non-sanctuary markets, these become determinative as to whether or not one can be successful in any market if indeed one competitor has the unique advantage of a sanctuary relationship.

So, the market in Japan directly is very large and could represent well over a $10 to 20 billion additional volume of business to American industry. But in Germany that is also the case, and there are some particular limitations in certain of the other markets that you spoke of which would be very appealing incrementally as business to American industry that is now becoming quite competent at matching costs and qualities if it had the right of access.

The CHAIRMAN. Mr. Chandler, I noticed recently that the Government of Japan asked all their producers of fine glass—glass for optical fibre and such—to get together for, as they stated 'a vision' for the industry. Now, I have a feeling that they are looking at a lot of exports in their crystal ball. Can you as companies compete against Japanese industrial policy when they decide to target an industry like that? What they are talking about is a meeting of government and business and financing, doing some extra research in that area, sponsored and helped by government, too. Can we handle that kind of competition?

Mr. CHANDLER. I think that clearly is going to be a difficult challenge. Today we are handling it. Today, as a matter of fact, we are producing optics in Rochester, New York, exporting them into Japan, and they are being incorporated in other companies 'products in Japan. But I think that the consortium that you described is going to be a formidable attempt to establish a foothold in what is going to emerge as an extremely important industry.

Optics clearly have a big role in the future of communications, and I believe Japan senses that and they will be moving strongly into that field.

Whether we can compete is a serious question. We surely want to. And to add to the other comments, for photographic goods, which are one-third of our business, Japan is the second-largest market in the world. For health care, which is another important business to us, I am sure it is the second-largest in the world, and my guess is it might be pushing ahead of the United States one of these days.

Those markets both use optics, they use electronics, and it is this combination of factors—of the activities of government, of company, and university collaboration in Japan that does produce a network that is very difficult to compete with.

The CHAIRMAN. That shows the significance of it, all right. Let me ask you another one.

I had a gentleman in my office yesterday, and he was talking about the buying of parts in this country; he was talking about it to the automobile industry. He said he had been trying to get into the Japanese market, that he has a quality product, and he said price didn't really seem to be that much of a factor. They had been trying very hard to get into that market, spending something over a million a year in just attorneys, negotiators, and that type of thing, and had made no serious headway.

He said that on the other side of the coin, that the Japanese companies moving into this country and manufacturing cars here have virtually a closed market to U.S. parts suppliers. They get their parts from Japanese companies. He said that if the Japanese develop 30 to 40 percent of the market for cars here, then in effect he is going to be denied the Japanese market for his parts in companies here and at the same time be denied that market over there. He said to deal with a Japanese company in Tennessee, now, is as tough as dealing with them in Tokyo.

Now, that is an interesting problem. Would either of you care to comment on that and on what that means in the way of parts?

Mr. CHANDLER. Certainly the scenario fits my understanding and my experience. I think it would be an accurate statement that says that penetration of the Japanese market at home—which is the only place we have tried to penetrate it—in Japan, is not a pricing matter, that pricing is not the way to penetrate the market. It is other factors, which are extremely difficult to describe and to delineate, because it is such a complex situation.

I would mention one thing that we have done with our company. We have two distributors in that country, one for photographic goods and one for information systems goods, and those distributorships go back 50 or 60 years. We have taken over control of those distributorships this year, in terms of managing them, and we are increasing market share—slightly, ever so slightly. We were not able to do that under local management.

The CHAIRMAN. Thank you.

Let me restate the sequence here. It is Senators Moynihan, Packwood, Baucus, Rockefeller, Bradley, and Daschle. We will limit questions to six minutes.

Senator Moynihan.

Senator MOYNIHAN. Thank you, Mr. Chairman. We welcome our two distinguished witnesses, and particularly, of course, Colby.

Before I get to questions—and Mr. Chandler will appreciate this—I would like to start off with a pronouncement: The United States has more trade with the Province of Ontario—which is directly down river and across the lake from you, Colby—than it does with the whole of Japan.

Colby, you said you hope this committee will give the President new negotiating authority, and I think our Chairman can assure you that we mean to do that—we are going to introduce a bill to do that this afternoon.

Mr. Galvin, you spoke of unfair trade practices and I heard you very clearly. Each of us is going to handle a component of the omnibus bill and I am going to be handling the section regarding unfair trade practices.

I would like to speak to a prior event, one which lingers. It would be just about two years ago that something unprecedented happened: The Kodak Company sent a letter to its shareholders, a very unusual event, called "The Dollar and Eastman Kodak." You said that the increased price of the dollar had cost the Kodak Company a billion dollars in profits since 1980, and that it was making the competitive situation overseas impossible.

You mentioned that you had been in Japan for 50 years, that you had gone toe-to-toe with Fuji, and that you had 10-15 percent of the market there and wanted more. And that, if the dollar remained high, a company like Kodak, the tenth largest exporting company in the nation, would end up a marketing company in this country—producing overseas, and not necessarily in Taiwan but perhaps in Toronto.

What has been the aftermath of that situation? Would you describe the initial experience, and have you begun to feel any effect from the decline in the dollar?

Mr. CHANDLER. Thank you. I would like to pick it up from that point in time.

By February 1985, the lost profits to us, measurably attributable to the dollar and its strength in relation to other currencies, reached $3.5 billion, and that was at the earnings level for us. Beginning in February 1985 the currencies began to move in the direction that would be more representative to purchasing power parity, to use one description.

There was a slight return effect in 1985, and this year another effect for us that is significant, and is significantly helping us this year; but in terms of recovery, if you want to think of it that way, of the $3.5 billion, we probably will be no more than 10 to 15 percent of the way back on that cumulative basis. On an annual basis, using our sales as an index of trade weighted balance, we might be half of the way back.

So, when I use the expression "20 to 30 percent more correction is likely to be needed before the fundamentals, say the currencies, are balanced," I am not only using our trade weighted figures but I am using available figures that others are.

Senator MOYNIHAN. Could I ask you if you think that the change in the value of the dollar was the consequence of the change of fiscal policy here in Washington? You seem to nod agreement. It was a fiscal policy—the huge deficits—that led to the run-up of the dollar and cost you $3.5 billion. Right?

Mr. CHANDLER. That is right.

Senator MOYNIHAN. Now, I would like to make this as gentle a proposition as I can, because it seems to me if we are going to make our way out of this situation, and it is a grim one, we are going to have to think about how we got into it. We are going to have to think our way through and reconstruct the events.

May I ask this of Mr. Galvin and Mr. Chandler: In the past, about four years ago, some of us began to make the observation that the deficits this Administration had created, $100 billion and then $200 billion—as far as the eye can see, had been deliberately created as a form of social discipline, to dismantle domestic programs of various kinds, intentionally, consciously, with full understanding that the deficits were going to be created.

Mr. Stockman has since written that in great and explicit detail and said it was "profound, the most irresponsible fiscal act in the history of the nation." Has that thought penetrated the business community? When you meet in the Business Council, do you ever talk about that?

Mr. CHANDLER. Yes. I think the business community is sensitive to that point, and I think the business community is sensitive to the fact that there is a no win-win situation in these matters of changing fiscal policy or moving the fundamental variables, and that it is a matter of finding what is best.

Clearly, we do center on reducing the budget deficit, which will probably drive the dollar lower, which will have some risk of inflationary effects; but if we control interest rates and thereby help the growth of the economies, both our own and those we trade with, it would appear to us that that is a sound policy.

Senator MOYNIHAN. Could I just leave you with a thought, sir? Just invoking the need to reduce the deficit doesn't address the fact that an Administration is in place which desires the deficit, sir. But that is another matter.

Mr. CHANDLER. I understand.

The CHAIRMAN. Senator Packwood?

Senator PACKWOOD. Mr. Galvin, on page 10 of your testimony, you talk about your theory of the annual surplus reduction goals—those countries that have unacceptable trade surpluses. Then on page 11 you say, "The purpose is to open free markets," that is what you are trying to do, is drive them open.

Do I take it, then, with a country like Hong Kong, we would not require any deficit reduction or surplus reduction because they have no limitations on our access to their market?

Mr. GALVIN. First off, the rules that you write if you do intend to write them are going to have to have a balance and an equanimity to them. But I believe, if there can be clear evidence that a market is absolutely open, then American industry and all industry must compete on its merits. I believe there is evidence that in certain key markets you not only have the result but you have the——

Senator PACKWOOD. No question. I just wanted to make sure what you were driving at. You are not really driving at increasing our tariffs. You are willing to trade; you just want them to let us trade.

Mr. GALVIN. Exactly.

Senator PACKWOOD. Now, the testimony we have had from two or three people so far is that if we could achieve that nirvana—open borders, openly arrived at, in all directions—that currently we would reduce our deficit by $20 to $30 billion, assuming we had access to all the markets we could get access to, bringing our merchandise deficit from $170 billion down to maybe $140 billion or $130 billion. You are saying, "Well, so be it. If that is the way American business comes out in a free market, that is where we come out." Or do I read you correctly?

Mr. GALVIN. No, not entirely. Certainly I agree that if however it comes out is depending on how well we compete, so be it. But don't undersell the confidence in American industry finding a way to redress this difference, if we know that we have a predictable opportunity.

Senator PACKWOOD. I think you are right.

Mr. GALVIN. I think the numbers will delight you—not surprise you, but delight you.

Senator PACKWOOD. I think you are right. What I find is that a number of people use your theory—and I agree with your theory—as a coverup for protectionism. They are not really interested in opening up the markets; they want to use them as a sub rosa argument to raise our tariffs.

Now, Mr. Chandler, let me ask you: On page 11 of your testimony you say, "First, I would urge you to give the Administration authority to negotiate tariff and non-tariff barrier reductions in the new GATT round." The President is perfectly free now to negotiate anything he wants. There is no limitation on the Executive to go to GATT and negotiate anything he wants. So, I am curious about what it is you are driving at.

Mr. CHANDLER. Well, I believe the President needs some authority for the quick resolution in the future.

Senator PACKWOOD. Oh, the fast track?

Mr. CHANDLER. The fast track, yes.

Senator PACKWOOD. After now?

Mr. CHANDLER. Right.

Senator PACKWOOD. Should we put any limitations on the fast track? And this is a debatable and highly-charged subject. You are saying we ought to be able to go to the GATT negotiations, he sends something back, and then in a reasonably expedited time we vote Yes or No on it?

Mr. CHANDLER. Yes.

Senator PACKWOOD. Would you put any limitations? Assuming you reach an agreement on "timeliness," 10 days or two months, or something, but the "timeliness" everybody says is fine—would you put any limits on that? Or would you say, to the President, "Go and negotiate anything you want, but you have to take the political flak if you make a mistake; Congress is not going to vote up or down?"

Mr. CHANDLER. No, I would have no problem with limits being placed on it. I do not believe I would be qualified to even make a suggestion as to what those limits might be; but it seems to me that that would be a reasonable approach.

Senator PACKWOOD. Well, here is the reason I asked: There are some who are suggesting that the limits ought to be that the Administration submit a trade policy, a rather detailed trade policy statement to us from time to time, and, if I understand it correctly, if we do not approve that trade statement, it negates the fast-track authority.

The argument that the Administration and others have used is that, if we are trying to negotiate, other countries won't believe us if they think Congress doesn't just have to vote up and down but can undo the whole thing.

Mr. CHANDLER. That is an area that is bothersome, if that is what could happen. If the description of the trade policies could be expressed in broadly enough terms that the committee could agree to it, and it could be done expeditiously, I think that would be a fine practice.

Senator PACKWOOD. I think I agree with you. I don't mind a trade policy at the start. But once you have done it, if you say, "This is as far as we will go from right to left on the trade policy, and we pass it Yea," then we say to the President, "So long as you negotiate within these parameters, that is what we think our trade policy ought to be," then it can come back on a fast track, and we will have to vote up or down.

Mr. CHANDLER. I would agree.

Senator PACKWOOD. Thank you.

I have no more questions, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Senator Baucus?

Senator BAUCUS. Thank you very much, Mr. Chairman.

Gentlemen, I think you would agree that a major part of the problem we have is cultural differences—around the world, that is. The Americans have a certain way of life, certain attitudes, and certain beliefs, and other countries have their own ways of life and attitudes and beliefs. And the world is very, very interconnected now, much more than it was 50 or 60 years ago.

That gets into the question of targeting, and whether the targeting should be actionable under, say, Section 301, and the degree to which it is appropriate and proper for the United States to file an action of the USTR, for the USTR to self-initiate an action that says Japan, for example, is engaging in targeting and that that is an unfair trade practice.

I ask the question, because I think it is true, as you say, Mr. Chandler, the world is different, with different people and different attitudes and so forth. And also I think Mr. Galvin is correct in pointing out that in Japan there is sort of a unified, cohesive attitude that they are going to work together. The Japanese are very proud of their country, as we are of our country.

I have a personal experience along the lines you were describing, Mr. Galvin, when you said the Prime Minister in effect cannot control and dictate what the bureaucracy can and cannot do.

Subsequent to the Moss Talks, when President Reagan and Prime Minister Nakasone agreed to reduce tariffs on various products—telecommunications was one, and pharmaceuticals, and also processed forest products—I was in Japan and somewhat naively went to various ministries, particularly the person in Japan in charge of working out tariff reductions for processed forest products. I went to him, Mr. Tanoka—not the former Prime Minister, but another Tanoka—and I said, "I am here to help you implement the agreement between your Prime Minister and My President to reduce the tariffs." He just sat there solidly in his chair and said, "My job is to protect the Japanese forest products industry," pure and simple. I mean, he wasn't going to budge an inch. He didn't care about that agreement.

The basic question is: What is proper targeting? How far can we go? For example, one could say that we have a targeting policy in our country. We have $27 billion of agricultural price supports, to push agricultural products for export. Is that targeting?

I would like to ask you to at least flesh out as best you can what kinds of targeting you think would be proper to unfair trade practices, what under Section 301 to define as an unfair trade practice, and what other kinds of agreements or understandings of priorities that a people in a country may make which would not be proper targeting actions and unfair trade practices under Section 301. Do either of you have thoughts on that?

Mr. GALVIN. I respectfully suggest, Senator, that this is a definable issue. I did not come prepared today to recite certain of the documentation on the issue; but, for example, I founded and led an institution that had a sunset provision to it called The Coalition for International Trade Equity, whose records are public, who have talked to the issue of targeting. We believe it is a definable phenomenon. We think it is something that is sufficiently definable that it could be actionable, and that there are differentiations between what certain of the collective state activities of some nations are versus what the United States does.

MOTOROLA, INC.,
Washington, DC, February 25, 1987.

Hon. Max S. Baucus,
U.S. Senate, 706 Hart Senate Office Building, Washington, DC.

DEAR SENATOR BAUCUS: During the trade hearings of the Senate Finance Committee on February 5th, you asked our Chairman, Robert Galvin, if targeting was definable. Mr. Galvin replied yes, that it is, and that it had been defined by the Coalition for International Trade Equity. I am enclosing for your information a copy of CITE's brochure which defines targeting on Page 1.

Following is the definition which appeared on Page 31 of the report which accompanied H.R. 4800: "Export targeting" is defined under section 301(e), as amended, as "any government plan or scheme consisting of a combination of coordinated actions, whether carried out severally or jointly, that are bestowed on a specific enterprise, industry, or group thereof the effect of which is to assist such enterprise, industry, or group to become more competitive in the export of any class or kind of merchandise."

Sincerely,

TRAVIS MARSHALL,
Senior Vice President.

Enclosure.

U.S. PUBLIC POLICY RESPONSE TO FOREIGN INDUSTRIAL TARGETING

The targeting for development of certain industries by foreign governments constitutes a significant threat to U.S. technological, security, and economic leadership in the world.

Targeting is the combining of government mandated or condoned practices such as home market protection, subsidies, and cartels to achieve a larger share of world markets in particular industrial sectors. Targeting is now pursued by many countries in industries where the United States has a strong international competitive position. While it is not always successful, when it is successful it can have dramatic competitive effects. Those effects can be very significant long after a targeting program has been terminated.

The adverse effects for the United States of earlier foreign targeting efforts are already evident in the serious erosion of U.S. jobs, world market shares and financial performance in many advanced sectors of vital importance to the United States, including robotics, machine tools, semiconductors, telecommunications equipment, and aircraft. This erosion can be expected to continue in these sectors and spread to others (including sectors that are not targeted directly but depend critically upon technology developed elsewhere in the U.S. economy) unless U.S. public policy begins to recognize and deal effectively with the problems. The industries targeted by other nations (see chart for a partial list) include most of the advanced sections that generate new jobs the economy, constitute our national technology and security base, and provide the impetus for the future productivity and international competitiveness of the U.S. economy.

The efforts of other nations to overtake U.S. firms in a wide range of sectors has generally intensified the efforts of U.S. firms to improve their international competitiveness. These include longer range business planning, improved employee relations, greater emphasis on quality and productivity, intensified research and investment, and more aggressive penetration of world markets. Such efforts must be encouraged and it is a major commitment of the members of this Coalition to do so. No public policy response will be effective unless U.S. companies make every effort to compete more successfully for global markets.

However, individual U.S. corporate efforts will often prove inadequate to offset the advantage that foreign government support and protection provides to their companies. Many individual U.S. companies generally cannot match the collective resources of another country or long ignore the added risks that stem from foreign governmental interventions. It is only through a broad U.S. public policy response that most American firms can be expected to successfully overcome these disadvantages.

It is the view of the Coalition that the current U.S. policy must be changed to provide a vigorous response to the efforts of foreign governments to promote their industries, if the United States is to avoid becoming a second-rate industrial, technological and military power.

The Coalition also believes that efforts to emulate the directive industrial policies of other nations are inconsistent with our economic and political values and probably would not be feasible in any event. We run the risk of creating greater distortions to our economy than would otherwise occur through such approaches.

Finally, our group feels that under existing circumstances the United States cannot succeed in persuading other countries to discontinue or curtail their targeting efforts. We strongly favor continuing negotiations, particularly at the bilateral level, but feel that such efforts will only succeed when the United States has defined and implemented its own national policy response to the problem.

BUSINESS ENVIRONMENT

A major element of the U.S. response must be creating an improved business environment—one which will provide stronger incentives for research and investment. Under this broad objective, the Coalition supports efforts to:

(1) increase U.S. scientific and technical workforce through education;

(2) remove antitrust barriers to cooperative research;

(3) provide additional tax incentives for corporate R&D and capital investment;

(4) increase government R&D funding for commercially oriented research programs;

(5) provide better protection for intellectual property rights;

(6) use tax policy to increase availability and lower cost of risk and venture capital;

(7) assure that U.S. technology is adequately protected from our adversaries without unnecessarily impairing the competitiveness of U.S. firms,

(8) increase U.S. export competitiveness by removing or liberalizing self-imposed government disincentives and assuring U.S. tax policy does not disadvantage exports;

(9) reduce interest rates; and

(10) achieve more realistic currency exchange rates.

There is little question that progress in these areas will enhance the ability of U.S. firms to meet the challenge of foreign industrial targeting. Yet, general domestic policy improvements do not provide a sufficient answer to this challenge. Certain additional policies, focused on the targeted sectors, are also required.

A FOCUSED RESPONSE

The second major element of a U.S. public policy response is the development of a U.S. Government capability to provide effective focused responses. The major components of that capability include:

(1) Monitoring, analyzing and publicy reporting on foreign industrial/targeting policies and their effects on U.S. competitiveness sector by sector.

(2) Supporting U.S. exports through programs designed to counter effectively foreign government support to targeted industries.

(3) Negotiating to achieve greater U.S. participation in foreign markets, with products that are being targeted accorded the highest priority.

(4) Giving the highest priority to preventing the effects of foreign market-distorting practices from injuring U.S. industries in the U.S. market through vigorous use of existing U.S. trade laws and updating of those laws to be fully effective.

(5) Mobilizing domestic policy to deal with particularly serious competition problems caused by foreign targeting practices where national security interests are affected.

Careful monitoring on a sectoial basis is critical. The U.S. Government must have facts and sound analysis on which to base its own actions. It must know what other governments have done, are doing, and plan to do in great detail. It should publicly identify on a regular basis the countries and sectors where foreign government efforts have distorted or may distort international competition with injurious effects to U.S. firms and workers. It should undertake intensified monitoring efforts where the potential for injurious effects is determined and should provide a mechanism for activating the appropriate form of response when such effects are detected.

Because injurious effects of foreign targeting can occur outside and inside the United States, it is essential that U.S. public policy be flexible enough to deal with both aspects.

Where the effects are felt in U.S. export markets, the U.S. Government should have an affirmative responsibility to provide whatever support is needed to offset the distortive effect of foreign government support. First, this would require an Export-Import Bank that is authorized and budgeted to match routinely export credit subsidies by other governments in the designated sectors. It may also require additional bank authority and budget to provide additional support to offset other distortive advantages.

We recognize that this represents a substantial resource commitment at a time of large budget deficits but feel there are compelling reasons for providing such support. Second, it will involve assigning the highest priority to targeted products in international negotiations for achieving greater U.S. access to foreign markets.

There should be particular emphasis on improved access to the markets of competitor countries utilizing targeting policies.

Where the effects are felt in the U.S. domestic market, the U.S. Government should have an affirmative responsibility to use U.S. trade laws to impose import duties (or their equivalent) in an amount sufficient to eliminate the inurious, distortive effects of foreign government targeting. We think this objective can be fully effected only by revising U.S. trade laws to make actionable all distortive targeting practices. The key concepts that should be embodies include an injury test that recognizes damages caused by reducing the U.S. share of global markets and discuraging adequate investment and research; imposing of duties that fully offset the market-distorting benefits of all targeting practices for as long as the effects of those practices continue to distort competition; provision for recovery of past damages; and using duties collected to restore competitiveness of damaged businesses.

in some cases where foreign targeting has fundamentally altered internationally competitive positions, it may be necessary to go further.

The Coalition feels this should be done where national security interests are involved and other actions will be insufficient to restore the competitive position of a U.S. industry. Under these circumstances, the U.S. Government should be prepared to mobilize domestic policy support for an industry. This support should be part of a coherent strategy which should inlcude such actions as selective direct funding, more, liberal tax treatment, and regulatory relief. The President should be empowered by statute to take such actions only where certain carefully defined conditions are met.

Senator BAUCUS. What would some examples of unfair targeting be?

Mr. GALVIN. When one has a stated law as Japan has, Public Law 17, Public Law 84, which laws specify the national intent to build and employ a collective industrial effort, that is significantly different than in the United States, where we engage in saying let's have the process of having American industry individually go out and compete. That is a specific.

There are numerous characteristic and profile factors that I can provide to the committee from the records of this coalition that can give you examples of that kind of thing.

Senator BAUCUS. Mr. Chandler.

Mr. CHANDLER. My comments are quite similar. I have read through lists of 301 violations prepared and submitted, I believe, through the Commerce Department, and there are a wide range of targeting situations that I think probably deserve considerable attention—not all of them on the list, in my opinion.

The collaborative effect such as the optic situation the Chairman mentioned is a good example. That kind of situation exists in the field of health care, where there are broad definitions of what is covered under their health care regulations that have a sweeping effect on any product that is brought into the country; whether it is a "pharmaceutical" or not, it may come under pharmaceuticals even if it is a piece of hardware. These essentially serve as barriers to entry.

Senator BAUCUS. What if they are not regulations, but just that the Japanese want to buy from Japanese? Is that targeting?

Mr. CHANDLER. Those exist, and I have not seen too many of those listed on the list of 301 rules. But that is endemic to the process, and they are hard to describe. They are practices, as are the ways that people function.

Senator BAUCUS. Thank you.

The CHAIRMAN. Senator Rockefeller.

Senator ROCKEFELLER. Thank you, Mr. Chairman.

Mr. Galvin, you have been a statesman in the United States/Japanese arena for many years, and you indicated what I would consider to be quite a tough trade policy as your preference. But then you also indicated that is not going to do it all, because the Japanese have a more deflected system of government, of consensus building, and of avoiding confrontation wherever possible.

My question to you is: What are American industries doing in a more sophisticated way to tackle so-called "non-tariff" barriers for the systems of collaboration underneath the policymaking level in Japan? And I will give you one example, which may be in error, and in which case you should correct me.

It is my impression that your company was trying to sell or has been selling car telephone units in Japan, and that you were attempting to do that at the same time you were participating in an anti-dumping suit with respect to Japan. Now, that I would interpret as selling, and also leading with toughness.

My question, one, would be: Has it worked? Does that kind of work within the bureaucracy prevail? Does it help you—the punch-counterpunch effect? And then, quite apart from that, what other kinds of things does American business need to do better in gaining access to the Japanese market?

Mr. GALVIN. Well, first, Senator, you characterization of what our individual institution is doing is correct; we are using the carrot and the stick, and so far are making more steps forward than are being retarded in our individual efforts.

The first thing that American industry must do—any supplier to any customer—is, we've got to run our business well. So the first thing that all of us have been doing—and, incidentally, there is an immense amount of it going on in American industry, led by companies like Eastman, but I think we are in there, too—we are learning how to block and tackle, produce with quality, very efficient, and so on, and, incidentally, are producing pagers in Fort Lauderdale, Florida, are producing cellular telephones in Arlington Heights, Illinois, and are selling them in Japan very competitively. So, we know how to operate our business.

But the specific thing that we are doing is that we are calling on a Bob Strauss, when he was the Special Trade Representative, and said, "We need an order for telecommunications." No one had ever sold a piece of telecommunications equipment in Japan until 1980. And he went over and opened the door as the ramrod to the Nippon Telephone and Telegraph Company, which got us our paging order.

Yes, we are attempting to cause that the American standard for cellular telephones would be adopted in Japan at this very moment. And it is essential that one of the legs to our stool is that the responsible authorities in the trade arena of our Administration are over helping to hold the door open so that we may have a chance to earn the business. We have the best product, the best prices, the best system in the world; it is the broadest view system throughout the world, and the Japanese are making products on our system and selling them into this market. They don't want to use our system over there.

The Moss Talks were aimed at opening this kind of a situation; but the Japanese are resisting, following the Moss Talks. So, what we do is, we use, legitimately, the authorities of U.S. Agencies to help us open doors.

Well, how many companies can these people help? They have to help everyone equally, but they only have a few people who can go over and negotiate. They can't be the salesmen for all of American industry.

So, what we obviously are proposing is that we need a generic approach to convince the Japanese globally, or in the grand manner, "You had really better open this market up," or they are going to have to take some penalties. Then we won't have to send our government representatives over there as our aides, allies, and blockers in order to open the next market.

Senator ROCKEFELLER. Let me ask another question to either of you gentlemen. I went to a university in Japan for a number of years in the late Fifties and early Sixties, and I have kept in touch with that generation of Japanese businessmen as they have come up gradually through the ranks and are now beginning to emerge, in Japanese fashion, at moderately higher levels.

The present Japanese generation of leadership does remember the generous American response after World War II, as does the present generation of Korean business leadership remember the generous American efforts in that war. It is my impression, however—and I am not saying that they have been soft as a result, anything but. It is my impression that in both countries leaders coming on in the business world are not going to have those memories, are going to be looking at an American business situation which they look upon as soft. They looked upon our dominance economically in the Fifties and Sixties and Seventies, and they saw wages and prices spiral, business and labor both soft in that respect, and their patience with our problems is short. They look at our budget deficits, and they are not impressed by our internal discipline; they look at our corporate salaries, our labor-management relations, and are not impressed. They look at their trade surpluses, merchandise trade surpluses, recognize responsibilities with the LDC's, will act upon those responsibilities to strengthen LDC's economies so as those become better markets, but have no real reason that I can detect other than the leverage that you talked about, Mr. Galvin, to be soft on us.

In other words, they have it going their way. They are probably tougher. They look at the Congress and see us trying to pass legislation, as with textiles. We did, but the President vetoed it. We couldn't override it, so the Congress has no particular policy. Does the country have any particular policy? Probably not. Therefore, they play us like a violin, our Congress and our public sector.

It is my theory that the next generation of Japanese and Korean leaders for those two countries is in fact going to be much tougher, much less responsive to pressure of the soft or internal variety that you have been talking about, and that our battles in the future are much more difficult.

Now, that is obviously an unanswerable question, but would you gentlemen speculate on that, based upon your experiences?

Mr. GALVIN. I will give a one-word answer, and then Colby can carry on: Amen.

Mr. CHANDLER. I agree completely with that scenario of possibilities. And that is why my position is that we do not change the results, certainly in the long term, by the combative approach that we are all working on day by day. It is very difficult to change personal behavior. Perhaps we can change it if we change some fundamentals.

If we can change our deficit situation, which changes the currency balance to a proper balance, and keep our interest rates down, maybe even lower, this forces the Japanese interest rates down. They have no incentive to put them down now. They have no incentive to make their economy go any faster, because they can ship their goods offshore. But if we can alter those basic economic factors, I think we have a chance of their seeing, then, the need for opening that economy. But that is our approach.

I think that the things we are doing—and I mentioned one thing that Eastman Kodak Company is doing—may bring slight improvements. And we are seeing slight improvement.

Unfortunately, we will not know for years as to whether that approach, of beginning to manage our distribution system there, was a success. And if it is not a success, by the time we learn that, it will be too late to do anything about it.

The CHAIRMAN. Thank you very much.

To show again the intense interest in these hearings, we have so far had 14 Senators who have been here for a time during the hearings, and I am sure we will have some more.

The sequence, again, of questioning will be Senators Bradley, Daschle, Durenberger, Heinz, Riegle, Matsunaga, and Danforth.

Senator Bradley.

Senator BRADLEY. Thank you very much, Mr. Chairman.

I would like to thank both of you gentlemen for your testimony.

Mr. Chandler, if I could I would like to get at the question of taxes and trade. If Japan exports goods to the United States they get dollars. If Japan doesn't buy an equivalent amount of U.S. goods, it has surplus dollars. And they spend their surplus dollars on U.S. Treasury Bills or U.S. investments from which they get a high return. Is that correct, basically?

Mr. CHANDLER. Basically, I think that is what we see happening. There is a multilateral opportunity that, when I talked to executives of Miti, for example, and said, "Why don't you put some of that excess capital in Latin America to help the debt problem," they show little interest. So I think what you describe is happening.

Senator BRADLEY. They want to go for the highest return. But isn't it necessarily the case that the bond financial sector of our economy is in direct competition with the goods-producing sector of our economy?

Mr. CHANDLER. Competing for the capital, yes.

Senator BRADLEY. To the extent that we sell more bonds, we necessarily sell less goods?

Mr. CHANDLER. Yes, I think that is sound arithmetic.

Senator BRADLEY. Now, if you are then thinking about taxes, and you have a big trade deficit, and you say, "Well, what we have to do to fight this trade deficit is give more tax incentives for investment," won't that necessarily increase the trade deficit, because you will have more incentives for investments, the Japanese will get higher returns—or the Germans or whomever—higher returns by taking their surplus dollars and investing them in those particular tax-favored investments? And necessarily, the result will be as more dollars go into those investments, less goods are sold?

Mr. CHANDLER. That is a fairly complex question, and I can deal with it a piece at a time.

I am not favoring incentives for industrial investment in this country that differentially affect companies. I do favor strongly a restructure, a reform, if you will, of our tax approach that encourages savings, which then is a channel to investment, and which does treat capital gains differently, and, finally, which treats corporate products, made by a corporation and brought into this market from overseas, the same as if they were made in this country, or vice versa.

Senator BRADLEY. But the point of the question is: Given a $170 billion trade deficit, we don't want to shoot ourself in the foot by passing laws that would increase the trade deficit.

Mr. CHANDLER. That is absolutely correct.

Senator BRADLEY. OK.

A second question: You say——

Senator DANFORTH. I am sorry to interrupt here, but you don't have to thoroughly agree with the line of thought that was implied in Senator Bradley's question, do you?

The CHAIRMAN. Gentlemen, let us keep to the order of questioning; I had a serious question myself that I didn't ask. [Laughter.]

Senator BRADLEY. I am glad to see that so many Senators are in attendance. [Laughter.]

A second question: You say that the current system of debt policy, Third World debt policy, is not working. Could you describe its impact on, say, jobs in the United States?

Mr. CHANDLER. During the period of, say, the Seventies or roughly that period for a company like Kodak, the Latin American market was growing at 15 to 25 percent a year. It was a stunning growth market much like Asia. In the last several years it has gone negative, for many years. It has now turned around and is going slightly positive. But with that overhang of a debt situation in Latin America, it affects us in many ways.

Number one: Country by country there is a strong pressure, if not force, for a company like us to match our imports with our exports, so that if we want to take goods produced by workers in the U.S.—continue to take them—into Latin American countries that have heavy debt, we have to look for ways to export products so that we have a balance of trade. And so we go around and buy natural resources, whatever, in order to do that. We engage in abnormal activities, activities that we are not skillful at.

It also affects our investment there. But it clearly does depress our export relationship. Forty percent of our market is overseas, and half of that we make in the U.S.

Senator BRADLEY. So, I take it you think that the way that policy has been handled has been to reduce the size of the U.S. export market in Latin America?

Mr. CHANDLER. It clearly has done that for us.

Senator BRADLEY. By a sizeable amount.

Mr. CHANDLER. Yes.

Senator BRADLEY. What is the amount, again?

Mr. CHANDLER. I don't have the figure memorized, but I believe we went down 40 percent.

Senator BRADLEY. A 40-percent drop in your company's exports to Latin America?

Mr. CHANDLER. I believe so.

Senator BRADLEY. Because of the way debt is handled. And that is the case primarily because the Latin Americans don't have the dollars to buy exports, to buy U.S. exports?

Mr. CHANDLER. That is correct.

Senator BRADLEY. Okay.

Let me, in my last question, ask: You say that the problem with the U.S. trade deficit is as much companies' as it is government's, and that companies have to take a longer view. What one or two things would you recommend that we could do to get companies to take a longer view?

Mr. CHANDLER. I know what the problem is. I am not sure whether the committee would feel that it could take legislative action.

But American companies report their earnings quarter by quarter, compared to the prior quarter, because this is a requirement, by FCC regulations. Companies in America like Kodak have their investments largely held by institutions—60 to 80 percent may be managed by institutions. It is a well-known phenomenon that an institutional holder is pragmatic enough to change their investment on short-swing gains, and their approach to corporations drives in that direction.

There is a third phenomenon that affects many companies, and that is the phenomenon of third-party intervention in buying up shares of companies, putting them under pressure, threats of takeovers and so forth. All of these forces drive American management to be too short-term in the managing of a company. It is a morass that I have described to you. If there is regulatory assistance in any of those areas, I am sure it could be of great help.

Senator BRADLEY. Thank you very much.

The CHAIRMAN. Thank you very much.

Senator Daschle.

Senator DASCHLE. Thank you, Mr. Chairman.

Mr. Chandler, I would like to go back if I could to your testimony and seek some clarification with regard to your view of the causes of the difficulties we face today.

I have no disagreement whatsoever with regard to the three that you mentioned—macroeconomic policy, the fact that the rest of the world is caught up, as you say, and finally the debt burden. But I hear it somewhat in conflict with Mr. Galvin, and we haven't really addressed the contrasting positions that you may have had; but I would be interested in your clarification or pehaps elaboration of how you view market access, when you look at the causes.

Mr. CHANDLER. I believe you are referring to market access around the world?

Senator DASCHLE. Market access abroad. How does that fit in the three causes that you have shown?

Mr. CHANDLER. At least in my experience, it is very clearly in the macroeconomic area, where from 1980 to 1985 the goods that we sell—not just in Japan but io Europe, in any market served by the major currencies where the dollar was strong in relation to the other currencies—we faced year after year approximately a 15-percent change in that relationship of currencies, which is equivalent to our having to cut our prices 15 percent, or equivalent to our competition raising their prices 15 percent.

Now, American companies traditionally have margins of 5 to 10 percent, the good companies. So you can see that being faced with that challenge four years in a row and then in the fifth year it was 7 percent, it is something that you have great difficulty offsetting with cost reductions.

Senator DASCHLE. But that alone doesn't explain to me the structural impediment that we find in other countries, the absolute prohibitions that exist on certain products being sold in a foreign country, the other kinds of tariffs and restrictions that exist on products sold abroad. It seemed to take into account something way beyond the relative value of comparative currencies.

Mr. CHANDLER. I think, at least in my experience, except for the Japanese market, price is a factor. It is the determining factor when you have product parity and quality and other respects.

Senator DASCHLE. Price is a factor, but, once again, how do you view market access? Is that the only factor in determining market access? Is that what you are saying?

Mr. CHANDLER. What I am saying is that it is an adequate factor to get market entry in other markets, except where we have described one country quite specifically here. There are other countries that prevent ownership, but those are beginning to soften—Korea, for example. We could not put a plant of your capital in Korea to do, say, a finishing job on a product, to package it for the market there, or any of those things. That is changing.

Senator DASCHLE. But you are not saying—are you?—that if we simply adjust the value of our currency and deal more competitively on the question of price, that we will alleviate our market-access difficulties. Are you?

Mr. CHANDLER. I am coming very close to saying that, if in the process, and I believe it would have to happen, we keep interest rates down and lower than they are now, and thus we have healthy economies.

Senator DASCHLE. Mr. Galvin, could I ask you to address that? I think I would have to beg to differ substantially, but you are the expert, and I would like another expert's view on that position.

Mr. GALVIN. Our experience is much to the contrary. As a matter of fact, to just add a little zest to the discussion, when you go to Japan you almost are invited to bid at a higher price, because that allows that the sanctuary phenomenon will continue there, so that the things that are done there can earn money, so they can afford to do things elsewhere.

So there are clearly a set of characteristics in a few countries, and there are a few more than Japan, who have determined collectively that they must resist buying from the outside for national interests. And price is not the sensitive item. They have all kinds of ways of affording these price differentials.

We have seen this now, with the dollar change in value, there have been virtually no changes in price in the United States. People find ways of absorbing that, because they peg so many other things they buy to the dollar, so they have an escalator that compensates for it.

There is a class of issues of a very timely nature, that I have spoken to here, that I think have to be dealt with in concert with all the other system's items, which are also very vital.

Senator DASCHLE. Thank you.

In the remaining limited time I have, I would like to ask something in reference to a comment that you made about the help that the USTR has been to you in the past in a personal way. Mr. Strauss and now Mr. Yeutter can take on specific assignments with regard to that market access that I think have been very helpful. But how do you view the relative ability of our USTR to that of other countries' to enter into specific opportunities such as this to our benefit?

Mr. GALVIN. Well, first of all, the personal ability of the people who are representing us is absolutely superb. They have the negotiating skills. When they are in the pits, they have the guts and so on to do it. But they don't have any backing that provides that consequential event if the person they are trying to negotiate with either agrees and then doesn't perform, or if he doesn't agree.

The art of negotiation does require power.

Senator DASCHLE. Thank you very much. Senator Durenberger.

Senator DURENBERGER. Thank you, Mr. Chairman.

Mr. Chairman, as I listen to these hearings I am reminded that the other night I was at a reception, and I was between votes and complaining about the pace around here. This wise old man said, "Gee, it must be tough working in such a complex environment with such complex issues." At the time I was between taking down billboards and increasing highway speeds, and my reaction was, "No problem at all. The complex issues we avoid; it is things like salary and billboards, and so forth, that we tackle," except in this committee. And I guess that is the reason I like it, and the reason I regret, and all of us regret, not being able to spend more time here.

In the last two years the Chairman of this committee and some other members of this committee were part of an experiment that I headed on the Intelligence Committee to design a national intelligence strategy.

Currently, in the Armed Services Committee—and this really started under Barry Goldwater—there is a similar effort to develop a national defense strategy. The ultimate, of course, is to have a national security policy.

None of these things are elaborate election-issue sorts of things, but it sort of pins people's responsibilities down ahead of time. In our case, we looked ahead 10 years, and we found that it wasn't just the Soviets we had to worry about, it was 16-megabyte chips in Japan, for example. It was religious fundamentalism, or Christian liberation theology, or—who knows?

The reason we were doing that—it wasn't a particularly sophisticated exercise, and we weren't doing it just for the exercise, but we were doing it because we had to vote on multi-billion-dollar budget commitments that won't be in place for five or 10 years.

So, it strikes me that in large part that is what I am getting out of this kind of a hearing. Everybody would like to look ahead five or 10 years, but it is difficult to do.

One of the things that came out of our strategy discussion was Bill Bradley's proposal relative to Latin American debt, where he disagreed with the Secretary of the Treasury. Mr. Chandler, I think you responded to some of the concerns there.

One of the questions we raised was why do we, in effect, treat all countries of South America the same? And we went right from that to: Why do we have the same trade policy with Brazil and 130 million people that we have with Hong Kong, which is about to be part of China?

And I think the answer is that we all think short-term, and nobody wants to break the mold and move on to something else.

My question of both of you is in the context that I have tried to describe to you. I am leaving aside the so-called complexity, but maybe just dealing with your personal frustrations on the conflict when it exists, or the opportunities between a national security policy for this country, which is not just the Army, Navy, Air

Force, and Marines, but in the much larger context of oil cartelization, population, high tech, and all the rest of it, and the trade policy.

Where should we all be heading? I mean, would you encourage broader discussion of these issues in the larger context not only of trade but of national security?

Like the story in The Times this morning on the 16 megabyte chips, for example, Mr. Galvin. Does this worry you? Or should this worry Americans, that we might in the future have to rely on the Japanese for that kind of technology?

Just where in the oil import fee argument that we have here periodically, where in our longer-range planning, should we be balancing international trade issues and the national security issue?

Mr. GALVIN. Senator, I think you raised the grand issue, and I will not speak in grand lengths of a statement. I don't ask you to turn the pages to it, but in my written testimony under the theme of ideology I speak of the fact that each of these other practitioners, many other state-directed institutions of various kinds, are results-oriented. That is a synonym for an ideology.

We are process-oriented in this country, and we decided that 200 years ago, and it has worked pretty darned well for us, because we want to have all the freedoms and the checks and balances, "So don't let anybody else tell me what to do and me tell you what to do."

I am saying here that I think we have got to modify our approach as a country, and we must be much more results-oriented. And if one wants to be results-oriented, then you have got to do some thinking in your head, you have got to do some planning.

I am as conservative a Republican class of thinker that one can have, and I understand the concerns of someone who says, "You don't want a national policy do you?" And yes, I do. I think that you should be encouraged to think about whether or not there should be a national policy that doesn't direct Colby Chandler to produce a given product, but what we want the results for this country to be. This country is an economic machine, and this economic machine must create wealth. Not wealth to put in your pocket or my pocket; I'm speaking of it in the generic sense. If we don't create wealth, we can't have the so-called "full-employment economy" that affords the social programs, et cetera.

The way we are drifting as the result of the other person taking advantage of the use of their ideology of being results-oriented, and if one of them succeeds, like Japan, is that they knock the rest of us out of the game.

I think that you have got to lead us for the next few years toward something that plans for an end-result good for this country.

Senator DURENBERGER. Mr. Chandler.

Mr. CHANDLER. Well, Mr. Galvin has said it very well.

Senator DURENBERGER. I agree.

Mr. CHANDLER. I feel that clearly we are competing as companies against countries, and against country policy which integrates government actions with corporate actions with planned university actions, in which thrusts are done in a cohesive, coordinated way, and the cost of capital is controlled to a very low level, so that companies basically fund their capitalization out of debt at a low cost, and at which it is favorable to export products.

It seems to me we do need to recognize in this country—and we have a large communication problem with the public in doing this—that it is important for America to be strong economically, that it is important that in that process our manufacturing sector remain strong, and that we have strong exports. For that to happen, it does require a closer understanding in our legislative process with our manufacturing process.

To illustrate that, I believe that if we look back at the Tax Law of 1986, which I think was a step forward, it did nevertheless treat manufacturers as though they were American manufacturers manufacturing to an American market and not to a world market. I think that illustrates my point.

The CHAIRMAN. Thank you very much, gentlemen.

Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you.

Mr. Chandler and Mr. Galvin, both of you have given us some good advice about what we can do here in this country to pull ourselves up by our bootstraps. We should reduce the federal budget deficit—although I might parenthetically add that as a percentage of GNP, our budget deficit looks pretty good to most other Free World countries. We should try to solve the LDC debt problem. That would help our export opportunities greatly and reduce the protectionist activities of countries like Brazil, we hope. We should do more to educate our own people in the right skills, and maybe figure out a way to reduce the numbers of lawyers and accountants. And we should have a better attitude, the kind of attitude that 30 or 40 or 50 years ago caused this country to be, first, the arsenal of democracy and the engine, thereafter, of Free World economic growth.

My question first to Mr. Chandler is: If we did all four of those things, would we still be able to obtain access to markets like Japan or Korea or some of the other closed economies that Mr. Galvin mentioned? Yes, or no.

Mr. CHANDLER. This is the second chance at the same phenomenon. Incidentally, I do not differ from Mr. Galvin in the description of that problem. I guess if we differ, we differ in the degree of optimism with which we can solve the problem by direct means.

I do believe, while our USTR is more successful than many of us are, company-to-company, in negotiating in some of those countries, that it is a short-term matter, for one thing.

Senator HEINZ. I didn't make my question clear. If we do all of the internal things that we are ultimately capable of, would that create market access opportunities in the list of state-directed, mercantilist economies of East Asia?

Mr. CHANDLER. I don't think anybody knows the answer to that question.

Senator HEINZ. I doubt that the answer is no.

Mr. CHANDLER. My position is, we ought to try, because I do not believe the short-term solutions are going to do it by themselves, number one; and number two, I do believe they are short-term, and I do think they can be counterproductive.

Senator HEINZ. Let me ask you this, then turn to Bob Galvin for a couple of questions:

Let us assume that he is right, and that your uncertainty turns into agreement with him that just doing those things isn't going to do the job, and what I call "mercantilist economies" and some others call "state-development economies" continue to become more and more successful. What does that ultimately force this country to do? Do we abandon the free market? Do we start subsidizing our industries? Do we start industrial targeting and become just like the other fellows out there and thereby change our system of values that we believe has served this country and this world well? Would that happen to us, or would something else happen to us?

Mr. CHANDLER. I think you could convince a lot of people that that scenario is what might happen. I personally believe it would be a cycle effect.

Senator HEINZ. I think a possible bad solution is that we would be forced to change, to become something that most Americans have absolutely no desire to become, which is state——

Mr. CHANDLER. I think once we start down that road——

Senator HEINZ. This goes way back to our roots in federalism and profoundly affects our psyches. We don't even like banks, let alone the government in this country.

Mr. CHANDLER. The question is whether we would have the ability to reverse that trend, and how soon, and how effectively.

Senator HEINZ. Now Bob Galvin, you have stressed that we should be more results-oriented, that our process-orientation—which parenthetically included keeping our markets open at the conclusion of World War II to the countries devastated by World War II, including countries that had been our enemies, our free transfer of technology and capital, and on occasion management by the multinational corporations—has served those countries and ourselves well.

But as you look at the trade imbalances, what you say is, that process isn't working anymore, and the only way we can get results is to legislate results.

My question is this: You indicated, in effect, support for what was last year the Bentsen-Gephardt-Rostenkowski bill. That is what you really said in the statement. You said that when we confronted the issue of reciprocity, Senator Danforth and I back in 1981 and 1982, the conventional wisdom was against requiring reciprocal market access based on national interests—that that was protectionism—and as a result what was enacted was weak. And you were saying, unless we take strong action of the kind you described, it will still be perceived to have a bad result, because it is process-oriented.

Let me give you an alternative, if I may, Mr. Chairman, just a brief alternative to the bill I described, which is this: Would legislation, which said that if there was a pattern of denial of market access, that the United States would be required to retaliate against such denial of market access by reducing or eliminating market access to the U.S. markets of the offending country; and that that would go into effect and remain in effect until a solution was negotiated, if and when that ever happened. Is that strong enough?

I guess you are going to have to give me kind of a short answer, because my time has run over.

Mr. GALVIN. Well, certainly it would express a very significant will and intent. I am not skilled enough, sir, to give you a snap answer, and you wouldn't want one.

I believe that the class of approach that was described in last year's legislation provided an understandable formula, a predictability of what could happen as a consequence to the person that didn't respond, and that we need something of a tangible nature versus just a qualitative nature in order to cause this change to take place.

Senator HEINZ. Thank you. My time is up.

The CHAIRMAN. Thank you very much, gentlemen.

Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

Mr. Galvin, hearing your comments today and reading carefully your statement, I have to say to you that I think you have brought us a brilliant assessment of the problem, and I thank you for it. I think you are uniquely situated by virtue of your own business history and what you have been doing in the international market to come and help to illuminate this problem for us in a way that we must bring ourselves to understand. That is not always easy. We can get facts, but whether we are able to take them and absorb them and draw the conclusions that we should from them, it just doesn't always work the way it should.

But I think you have given us a way here to understand what underlies the difficulties and the blockages in this international trading system that more of the same, in terms of our response, cannot by itself solve. We have got to do some new things.

You have mentioned specifically target deficit-reduction goals with the nations that have these huge bilateral surpluses with the United States, and obviously Japan leads that list; but we have—out in that part of the world—Korea and Taiwan coming up very rapidly into the same situation.

You are saying to us, as I understand it, that if we produce trade legislation or a national strategy to deal with these problems, and we leave out something that is going to make sure that we get systematic deficit reductions in the areas where they are the largest, for these ingrained reasons, that we really will not have addressed the problem. Is that a fair summary?

Mr. GALVIN. Yes, sir.

Senator RIEGLE. Now, we have a trade bill that we are going to introduce today as a committee. I don't know if you have had a chance to review it yet, but it is being offered as a full bill, and then it is being offered section by section, so that those that agree with all of the sections can so indicate, and those who might reserve a judgement on a section or two can also indicate that.

I am going to indicate to you, and I want to indicate to the Chairman and to the members of the committee, that I will be offering—as soon as I can draft it properly—a deficit-reduction section of that bill, because I think it is the heart of what is needed to make a trade bill work. Now, obviously it has got to be balanced, and it has to fit all the constraints, and so forth.

But I think your recommendation to us is so powerful and so necessary, that I think it has got to be there, and I just want you to understand that I am going to do my best—and I hope you will help, work with me and others who may have that interest—to see to it that that part gets drafted properly and put in there, so that we get that piece of national strategy or trade-policy strategy in place.

There is another area with respect to worker-rights that is off the topic that we are talking about now that I think also needs to be in there, and so I will be drafting that and offering that as well, because it seems to me that if we don't turn these trend lines around now, we may not have a chance to turn them around in the future.

I would refer you to a chart here—it will just take a split second to do this. The first chart that I have here is a chart that shows our trade deficit over the last several years of the balance of trade, just to show the expedontial change in this trade deficit through the end of last year, which takes us to this $170 billion figure. But I show you that in terms of a kind of income statement on our trade problems.

But to go to what I think is the more serious problem is the balance-sheet problem. We do such an elaborate ballet around issues here oftentimes in the Congress, that, you know, we are talking about yesterday's problems and old textbooks and past theories, and so forth. This to me is the problem we are facing where we now have become a debtor nation. We are the number one debtor nation. We are adding new international debt at the rate of a billion dollars every two and a half days; we are going to owe the rest of the world a trillion dollars by 1990, according to the New York Federal Reserve Board's latest estimate. And we are impairing our international balance sheet in a way that we have never done in modern history; we were a creditor nation going all the way back to 1914.

My question to both of you is: As we continue to plunge into this debtor's hole, and that is exactly what we are doing, that is the trend line we are on, on a chart that is to scale, at the present time, can we allow this to continue? And if we do, what does this mean to us? If we impair our international financial position at this rate for any length of time into the future—two, three, four years—what does this mean for us? What is your sense for it?

Mr. GALVIN. I am going to give you an electric word, and it relates also to John Heinz's theme that he was enunciating as he was pursuing his fundamental question—and I am sure the record will show what it is; I won't repeat.

Sir, that line leads to receivership. A receiver is a dictator.

Now, let me back off. I don't mean to say that our society is moving towards a czar of that magnitude. But whenever an institution finally owes more money than it should, someone imposes a discipline. And in the business vernacular, that is "a receiver."

If the Eastman Kodak Company or Motorola ever goes into receivership, we stop having the freedom to run our affairs the way that we want to, and that is what John was getting at a few minutes ago. We are at risk of losing our wealth-creating capacity to work ourselves out of this problem and we are rapidly moving down this curve way too fast. And if we get to the point where people in the rest of the world don't have the confidence that we can pay off our debts, a phenomenon of receivership will occur, and even the members of this committee won't have the freedom to do what they thought they had the right to do under the Constitution, because of influences from the outside. And, absolutely, the Colby Chandlers and the Motorolas are going to be far more restrained.

I think that is the significant and predictable consequence if these class of things are not dealt with—and incidentally, at least in the next Administration. I think it is that imminent in terms of our ability to demonstrate our wealth-creating capacity to pay our way.

Senator RIEGLE. Mr. Chandler, my time is up, but I would like to have your response on the records.

Mr. CHANDLER. I intend for my comments to not diminish but maybe exaggerate more. I just think that that was not an understatement.

It seems to me that, as the debt gets greater, those things that you attribute to being caused by debt begin to exacerbate the problem; it becomes self-compounding.

I was in Davos earlier this week. The Europeans were saying that other countries that get into the situation that America is now beginning to face go into default, "What is the United States going to do?" We aren't there yet, but we are not going to go into default, I surely hope. But it is a serious matter. It means we are exporting our capital to pay the service of debt instead of to buy goods. We are importing capital to fund the debt. And the American productivity is going to have difficulty growing, because we do not have the formation of capital to put in efficient plants.

The entire process is compounding, and it gets steadily worse. And the digging of the hole is a good example; we must turn it around.

The CHAIRMAN. Thank you, gentlemen. Let me say that we have a large quorum out there which could turn into a vote, and I would like to move along here.

I really hope America is listening to what is being said by these witnesses, because it is highly significant and, frankly, fundamental and dramatic.

Senator Matsunaga.

Senator MATSUNAGA. Thank you very much, Mr. Chairman.

Thank you, gentlemen, for sharing your views with us. I think those of us who have not been able to listen to your testimony at least have your written testimony, and we will be sure to study them.

How would you respond to the criticism advanced by the Secretary of Commerce Malcolm Baldrige and the Assistant Secretary of Treasury Richard Darman, that American business is largely responsible for our present competitiveness problem?

Mr. GALVIN. I think they did a disservice to American industry. That unfortunately represents this wonderful phenomenon of our society, that we really can't stand up in a positive way to associate with each other.

But like every statement, there is some truth. And there are inadequacies in the operations of businesses, as there have been inadequacies in every other element of our society.

But the current evidence is that American industry has taken that challenge unto itself, years ago, and is working its way up to a level of quality management, good low costs, quality of product, et cetera, to where we can stand toe-to-toe with any competitor anywhere in the world on a wide variety of products.

Incidentally, our trading competitors, have some failures in some of their methodologies as well.

American industry can meet the competitive challenge if it has the confidence that the environment in which it will employ its investments can be earned. And I believe that American industry, if assisted—and I don't mean subsidies—if assisted by an environment from the Federal Government, with a statement of intent that we want America to really be competitive, could respond and recover even some of the businesses that we have lost.

Senator MATSUNAGA. Mr. Chandler.

Mr. CHANDLER. I think generalizations are always dangerous to make, and I believe those generalizations were were grossly unfair to many and probably on target for many.

The American companies have responded to what I characterize as basically the "strong dollar phenomenon," the overvalued dollar phenomenon, and have been working, I agree, for several years, and are in a much better position today to compete on a manufacturing basis than ever before. And I am confident, in terms of the industries that I am familiar with, that in terms of factory, management, and productivity, this country is close to world class, and the only thing that separates us perhaps is in the form of capital formation in some plants. We know how to do it.

If we want to try to put it on an average basis—and statistical averages sometimes are deceptive—in the years past, over the last five years, I believe you can put together some pretty good data that would say that that element of the problem—factory management and company management—has been about a third of the competitive disadvantage. The other two-thirds have been currency misalignment and, finally, the subject we spent so much time on, and that is the interweave of tax and barriers of entry. Those three factors are about equal.

Senator MATSUNAGA. As legislators, we are very much concerned about providing the environment which you suggest we should provide, to make American business much more competitive than it is today.

The CHAIRMAN. Let me interrupt just a moment, if I may, Senator. We have a vote on the floor, and I would urge that a number of you come with me, except for those who will speak next and question next.

Senator Matsunaga, if you will, please preside. And we will be back as soon as we can.

Senator HEINZ. Mr. Chairman, I ask unanimous consent that my prepared statement be made a part of the record.

The CHAIRMAN. Without objection.

Senator MATSUNAGA. Gentlemen, if we may continue.

Mr. Kobayashi—of the NEC in Japan—made this statement. "You Americans have a lot to learn. We Japanese come to the United States to find out what the American consumer wants. We go back to Japan, manufacture those products, and export to the United States. What do you Americans do? You go to Japan, and you set up factories. You produce goods for consumption by Japanese consumers? No. For American consumers, to export to the United States, adding to your trade deficit."

Now, this bothers me, because I have looked into this, and I find that through the international conglomerates, international corporations headed by those American industries, this is in fact going on. American industry is in fact adding to our trade deficit by going abroad, employing cheaper labor, and manufacturing goods to compete with American producers.

So, what is the answer to this? You want us to provide the necessary environment. Are we to do something about this? I understand both of you are very familiar with this, because you do have international operations.

Mr. GALVIN. Mr. Kobayashi is a distinguished world citizen and a superb leader of his country, and there is much that he has stated that is an accurate profile or description of the situation.

We haven't the time to go back over all of the reasons why the environmental conditions when those things started back 15 years ago, and did persist, took place. I think you will find that there were some survival reasons why that had to occur because of, then, some public policies.

But let us get around to changing things. It is my personal view that the American technology—not the science, but the whole ability to do business—has come full circle to where it is now able to compete from this shore to a much greater degree, and that if we—and I mean "we" as citizens, and I have some personal ideas, which I am now beginning to act on—can find a way of creating this "right environment," I think we can start to return to the United States' shores a greater balance, a greater mix, of the supplying of our own needs.

I believe that ought to be one of the positive objectives that you might wish to relate to, and I believe a number of Americans would like to identify with that, also.

Senator MATSUNAGA. Mr. Chandler.

Mr. CHANDLER. Yes. In our company's situation, I described—perhaps it was before you joined the group—that for our trade-weighted currency effect, to take one variable, we are about half-way back to what I would call "a proper balance" for trade-weighted parity, purchasing power parity, from the extreme that we reached in February of 1985.

In just that short interval of time, and in that 50 percent return to what would be a proper balance, we have been able to start some manufacture that is financially successful, viable, in this country. So that supports what has just been said.

This country is capable of competing when the fundamentals in the economic system give a proper "level playing field," to use an overworked expression.

One other statement I would make is that in our company's situation, every product that we have sourced as a product offshore, we could not produce in this country at a profit. And the only reason we are producing them offshore is to keep our position in the market. In other words, the companies have to survive, and this is a survival process we are talking about.

Senator MATSUNAGA. I wish we had more time to go into specifics on this, but we don't, and I have another commitment. I am turning the committee over to Senator Baucus.

Senator BAUCUS. Senator Chafee?

Senator CHAFEE. Thank you, Mr. Chairman.

Gentlemen, you both represent companies that have a tremendously high standing amongst the members of this committee and the American public, so I think you represent what we would call well-run companies.

On page 22 of this Challenge of Global Competitiveness that we signed here—and I am not sure who distributed that—there is a very tough speech by Secretary Baldrige, which basically deals with the ability to translate things from technology into production. He talks about VCR's, he talks about robotics, he talks about transistors.

My question is, setting aside the past as I think what we want to do is look to where we are going from here, do you think that the tools are in place now, or do you have some specifics? I know that number one through 10 for both of you is to reduce the federal deficit. But that is not solely within the jurisdiction of this committee, by a long shot. My question to you is: Are conditions better for translating technology into production than they might have been? And what might we do to help to solve this problem, which American industry is frequently accused of failing in, that your research department comes out with a marvelous idea and nothing happens; the Japanese grab it and make millions of dollars out of it?

Mr. Chandler.

Mr. CHANDLER. In the case of our company, we have made major restructuring within the company in the last say four years. The single goal from an operational point of view of that change was to do exactly what you described, to better couple the steps from research to development to manufacturing to the marketplace. Our management goal was to put the decision process down at a level in the organization that would enable that to take place.

This clearly was something we could have been criticized for not doing as well as we needed to do. At the same time, it is something that would not have been appropriate 15 years ago. Our product mix has changed. And so there is no such thing as a panacea for all companies. We were slow in doing it. We have done it. It is working. It was not something that legislative change would have helped or not helped; it was an internal change on our part.

I would make one other comment, that I think American companies are going to look different than Japanese companies, as we have been talking about Japan, because we start at the basic research and work our way through. If you are following another technology that is already established, you do not start back at the research but start at the process step.

The Japanese industry has done an admirable job of refining process technology and improving that process technology to make good products. They are now, in new areas, integrating back into research; but I think the comparisons, looking backward from this point, in the products I am familiar with, they are not comparable situations.

Senator CHAFEE. What about you, Mr. Galvin? What do you think?

Mr. GALVIN. Yes. The competence to accomplish what you refer to as "an objective" now exist. It must be spread across the panoply of American institutions.

So the part that is do-able by business, we now know how to do it, lots of people could replicate it, and they could be successful. They clearly have to have this environment in which they can have the opportunity to earn. And so, in trade policy areas, people at least like myself are speaking up for some rather specific and rather consequential events, because, in the translation of the next technology, we must watch that the following does not occur:

The Senator from Hawaii referred to the proposition expressed by Mr. Kobayashi of NEC. I don't think Mr. Kobayashi personally said this, but one of Mr. Kobayashi's principal executives said, and it is in the public record, that we could never have achieved a successful semiconductor industry in Japan if we were not protected. We had to have sanctuary.

So, if we are going to think of the total world system of America translating even a renewal of old technology or the achievements in new technologies, at the instant that we have that technology, Americans must have the right of access to the foreign market. That sanctuary can't exist. The infant industry phenomenon cannot be allowed to persist in developed nations.

Senator CHAFEE. Let me ask you a quick question, because I have to go over and vote. In the Tax Bill we reduced the investment, the R&D tax credit, from 20 to 25 percent. And we haven't made it permanent, but I think we are. But let us say we are at 20 percent now. Is that good? How significant is the difference between 20 and 25 percent on the R&D tax credits?

Mr. GALVIN. It is counterproductive. It sends the wrong signals.

Senator CHAFEE. But on a scale of 1 to 10, is it a great big 10? Would you dance in the streets if we gave you 25 back?

Mr. GALVIN. Well, everything is incremental, Senator. No, we wouldn't dance in the streets, but if you send three or four good signals to us, it makes a difference; versus three or four counterproductive signals.

Senator CHAFEE. What do you say, Mr. Chandler?

Mr. CHANDLER. I think the signal is more significant than the economics. We do not make any decisions that are based on that kind of financing—financial impact. It does not affect our decision process. It is an important signal. We need more signals to favor capital formation in this country.

Senator CHAFEE. I am sorry, I have to dash.

The CHAIRMAN. Gentlemen, I am going to take advantage of the fact that none of the rest of them are here. [Laughter.]

We could talk to you two fellows all day, but time won't allow. I understand we are going to have another vote in a few minutes, so we have another witness. You have been very helpful, and it is obvious from the participation that the members of the Committee have been most interested. Now, I will get to the next witness, thank you very much. We are most appreciative.

Our next witness will be Mr. William Lilley, President of the American Business Conference.

Mr. Lilley, we are pleased to have you here. Please proceed.

STATEMENT OF WILLIAM LILLEY III, PRESIDENT, AMERICAN BUSINESS CONFERENCE; BRONXVILLE, NY

Mr. LILLEY. Thank you, Mr. Chairman, and thank you for inviting the American Business Conference to appear.

Let me say a word first about the American Business Conference. It is made up of 100 chief executive officers of mid-size, high-growth companies.

The CHAIRMAN. Mr. Lilley, we have an audience back there that wants to hear you, too, and if you will, speak right direc ly into that mike, pull it up, chew on it a little.

Mr. LILLEY. All right.

The size of the companies range from $25 million in revenues to $2 billion. The average size is $370 million in revenues. The average rate of growth for the companies is 35 percent. Each year they increase their job force, their employment base, by about 14 percent, over the last five years. The companies are spread evenly across manufacturing and high tech manufacturing and service sectors.

What is perhaps unusual for a Washington organization is that the member companies have to achieve a very high rate of growth to get into the organization, and, if they do not sustain that rate of growth, they have to leave. And about 20 out of the 100 leave each year.

The CHAIRMAN. Mr. Lilley, I relate to that kind of a company; I was the chief executive of a company in that area. I remember that Bob Galvin and I belonged to an outfit called YPO together as chief executives of our respective companies, and there the similarity ended; his was a very large company and mine was a relatively small company. But I know what an innovative, creative group of companies that is, and we are appreciative of your being here.

Mr. LILLEY. Thank you, sir.

Last fall, in anticipation of what was going to happen in this committee and elsewhere in the government, we initiated an extensive survey of the chief executive officers of the American Business Conference about international competitiveness and how it was affecting economic growth, both in their companies and in general in the country. We asked them how important international competitiveness was, we asked them how they were doing, we asked them what problems they are having, and we asked them what they wanted the Federal Government to do about the problems.

Today we are making public our findings, and we have provided the Senators with a copy of the report. It is the gray one that Senator Chafee mentioned. In the report, the first appendix is the survey questions for which we received professional assistance from McKinsey and Company in designing; also in an appendix are the member companies by state and type of product or service.

As to how important the CEO's thought international competitiveness was, they said it was extremely important. Seventy-five of the 100 companies participate actively in international competition. Twenty-five are involved in cable television and broadcast television, newspapers, domestic oil and gas, but by their nature are not internationally involved; the others seventy-five are involved internationally.

Perhaps the most interesting finding—and we did not expect this finding—was their answer to the question: How well or how poorly are you doing? They are doing extremely well. From 1980 to 1985, their revenues, internationally derived, increased 230 percent, or, annually, 27 percent.

Similarly, they project from 1986 to 1990 that revenues will increase 225 percent, or 26 percent annually.

To give you an idea of how this growth has fueled their overall growth, in 1982 only 13 percent of their total revenues were internationally derived; in 1985, just three years later, 22 percent were internationally derived.

We asked them how they account for this remarkable rate of success, particularly remarkable given the reports and the media climate that many American companies and industries are not growing and perhaps even declining. They all attributed it to the way they run their companies. They stressed, repeatedly, aggressiveness, agility, risk-taking, patience. They talked about opening international markets as if they were going to war. The most commonly-used phrase was "to secure a beachhead" and to try to judge how big your losses would be initially to go in and take that beachhead. And all of them talked repeatedly about product quality and marketing quality. And the words heard again and again were "quality, quality."

If you would look in the little gray book we have given you on page 10, there is an interesting chart which we compiled from their answers. We asked them to grade themselves in basic business skills against their foreign competitors. There is about 10 different inditia there. On all of the quality-related ones they grade themselves ahead of their foreign company competition; on the cost ones, they grade themselves behind.

The rest of the report was not as unrelievedly good news as the first part. Even not withstanding this rate of success, all the chief executive officers consider their future success abroad to be fragile, and they rank three problems that make it fragile. In rank order, they are:

First, because they are not the low-cost producer, they therefore are vulnerable on the cost front, and hence control of costs is very important. And in ranking costs—and they rank what are their different weights of cost on page 17—the cost of capital for them is very high; whereas, the cost of labor is their lowest cost.

As companies—and they all in one way or another made this point, and I think it is a point I heard the Senators asking the previous witness about—they see themselves as different kinds of industrial or high tech or service companies than the 1950's, 1960's, or 1970's. They see themselves chiefly as value-added companies, quality producers. They see themselves as capital-intensive, knowledge-intensive, technology-intensive. They contrast themselves in almost every case with the kinds of companies from the 1950's and 1960's that made the American economy, worldwide, dominant. And those were companies that were labor-intensive, resource-intensive, volume-intensive, low-cost producer-type companies.

The second biggest problem that they face—and this goes to the previous questions—are cultural barriers abroad. By "cultural barriers" they mean the bias that they face, particularly in the Common Market countries and in Japan, toward locally-produced goods. They attribute about 20 percent of that bias to cultural chauvinism in those countries. They attribute the other 80 percent to the belief in those countries that locally-produced goods are of higher quality than American-made goods. And a number of CEO's reported instances of when they entered particularly the Japanese market, of how they had to upgrade the quality of their product in order to make it successful.

Lastly, in terms of problems, they cite foreign-imposed government barriers. They are listed on page 18, the ones for Japan, the Common Market, Brazil, and South Korea.

Finally, we asked them what they want you to do to help with the problem. There are five things they would like done, and, above all, two are the most important.

The first is that they want the Federal Government, at all costs, to avoid protectionism, at all costs to avoid any steps that limit imports, because they feel that will limit growth.

They also feel and have specific evidence, themselves, that in any retaliatory cycle that starts, because they are the companies that are enjoying success abroad, their products, their services, those are the ones who are expanding markets abroad, that they are the people who are taken hostage. That is their first request: Avoid protectionism.

The second—and we have heard it this morning—is to reduce the size of the domestic deficit, particularly because of their concerns about the relatively high cost of capital and the reduced amounts of savings in this economy.

After those two, far down the list, are three others:

The third would be that your committee recognize that the problem of cultural barriers abroad, particularly the quality problem, has been a long time in coming, and it makes it very difficult for you—now that people are asking this government to solve the problem. They would like you to understand that they understand that a problem that long in coming is going to be some time in solving. It goes to our educational system, labor-management relations, a whole host of institutional arrangements in this society.

Another thing they would ask be done would be that the export licensing program of the United States be streamlined. They don't want it abolished, but 52 percent of our companies are affected negatively by the export licensing program.

And lastly, and I think a position that would sharply distinguish our executives from Mr. Galvin's position, for example, is that they would ask the government that, when it moves on unfair trade barriers, that it do so in a scalple like fashion, with a high degree of flexibility, and that it not be pursued in a way that—for them, for what is the fifth priority problem—be done in a way that jeopardizes the first priority, which is to start some sort of trade retaliatory cycle.

Thank you very much.

[Mr. Lilley's prepared statement follows:]

STATEMENT OF WILLIAM LILLEY III
PRESIDENT, AMERICAN BUSINESS CONFERENCE
BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE

February 5, 1987

I am pleased to testify today on behalf of the American Business Conference (ABC) on the issue of American trade policy. Mr. Chairman, you and the Committee are to be congratulated for holding hearings on this important matter before crafting remedial legislation. Only by seeking information from a multipiicity of sources can the Committee take adequate measure of the likely effects, for good or ill, of any initiatives.

Earlier this morning, Arthur Levitt, the chairman of the American Business Conference, and I released a report summarizing an extensive survey of ABC members on the related problems of competitiveness and trade policy. I would like to submit that report, entitled "The Challenge of Global Competitiveness: Views of America's High Growth Companies," for the record. Much of my statement today will be based upon the findings of that study.

The American Business Conference is a coalition of one hundred chief executives of midsize, high growth companies. At minimum, ABC companies must demonstrate an annual revenue growth at a level three times the growth of the economy plus inflation. In fact, the average ABC company grows at a far higher rate -- about 35 percent per year. The average annual revenues of ABC companies is $370 million. ABC companies are creating new jobs at a median rate of about 13.5 percent annually.

ABC companies are distributed across the manufacturing and service sectors in proportions representative of the economy as a whole. As high growth firms, they tend to be capital intensive, knowledge intensive, and greatly dependent upon technological and marketing leadership. ABC companies are the sort of value-added manufacturers and value-added service firms upon which many have placed their hopes for America's future.

Last autumn, in anticipation of the great debates on trade and competitiveness that lay ahead, Arthur Levitt and I decided to survey ABC executives regarding their companies' international business. We already knew that about three-quarters of ABC firms derived significant revenues from abroad. Our thought was that a systematic examination of how international revenues are earned by some of America's most successful entrepreneurial companies might be of general interest and, perhaps, of use to policymakers.

"The Challenge of Global Competitiveness: Views of America's High Growth Companies" offers a full discussion of the ABC survey. I want here to mention a few of the more notable results:

* ABC companies are increasingly dependent upon foreign revenues as a fuel for their overall expansion. In 1982, 13.6 percent of the total revenues of ABC firms were derived internationally. In 1985, that figure had risen to 22.1 percent.

* Between 1980 and 1985, ABC firms increased their internationally derived revenues at a rate of 27 percent annually. ABC executives predict a similar growth for 1986 - 1990.

* ABC companies compete on quality, value, innovation, and service. They almost never compete on price alone.

* ABC executives reject the supposed primacy of labor costs in explaining this country's lack of competitiveness. They stress instead the importance of controlling total costs -- especially for market access, capital, and taxes.

* ABC executives oppose protectionist legislation.

* ABC executives believe that successful international competition is fundamentally a question of managerial will and skill.

As encouraging as these findings are, they should not be taken as evidence that ABC executives are sanguine about America's future in the international marketplace. The reverse seems true. Our survey revealed considerable distress among our membership regarding the related issues of the domestic deficit, an unstable monetary climate, increasing foreign indebtedness, and a relatively high cost of capital.

You have heard these concerns before. Every member of this Committee has voiced them. In Washington, they have taken on an almost totemic status.

Nonetheless, these issues, familiar as they are formidable, remain of first concern to the executives I represent. Fairly or not, ABC members believe that the government is in a better position to do more for business's international prospects by a renewed battle against our fiscal and monetary problems than it is by passing legislation designed to police the trade policies of other nations.

To be sure, trade barriers do exist. Our report lists those impediments to trade most commonly encountered by ABC executives. One of the most frequently mentioned is immediately amenable to governmental remedy: our own export licensing system.

Few issues have generated such needless controversy. No ABC member affected by export controls wants to do away with them. ABC executives do believe, however, that the process for obtaining an export license is unnecessarily cumbersome and marked by inter-departmental squabbling. The delay can cost sales since other nations administer their licensing programs more efficiently. Lost sales mean less money for research and development. Less R&D means loss of technological leadership. An unnecessarily restrictive or capricious export licensing system, in other words, is a kind of "reverse protectionism" that is no more to our benefit than its more traditional counterparts.

ABC executives also face foreign trade barriers. Given the remarkable record of international success enjoyed by ABC companies, it seems fair to assume that the foreign trade barriers identified in our report are real and not merely rationalizations for poor retaliation can hurt companies like those of the ABC in at least two ways:

* U.S. imposed restrictions on imports would directly hurt the business in this country of member companies who import the affected product either for resale, or as a component in a final product sold in the U.S. or abroad.

* If a trade war results from U.S. retaliation, the foreign country may erect new barriers against the sale of member companies' products or services in the foreign country. Because ABC companies have been very successful in doing business in foreign countries, they are particularly vulnerable to such retaliation by foreign countries.

We frankly have seen nothing in the new retaliatory initiatives that reduces the risks they would pose to American companies that are succeeding internationally. That is hardly surprising. It is one of the perversities of protectionism that it inevitably results in the punishment of domestic companies that have penetrated foreign markets.

Mr. Chairman, the challenge facing American business today is not so much unfair competition as it is competition pure and simple. Any trade legislation worthy of this Committee's attention should be designed to nurture success rather than simply to protect failure. It cannot be allowed to camouflage the central macroeconomic problems that must, sooner or later, be addressed if we are to earn -- rather than borrow -- a standard of living commensurate with our citizens' rightful expectations.

The CHAIRMAN. Thank you very much for your testimony.

You pose a bit of a dilemma for us here. The statement was made earlier that four years ago reciprocity immediately meant protectionism, but that that feeling certainly is not as strong nowadays.

It seems basic to me that if a country has full access to our markets, we ought to be able to demand full access to theirs. Do you quarrel with that?

Mr. LILLEY. No.

The CHAIRMAN. All right. Well, then, how are you going to get it? Suppose they resist it, how are you going to get that full access? How are you going to pressure them to bring it about? What are the realities? Let us face up to reality in this situation. Is it fair for one side to have protectionism and the other side not to have it?

Mr. LILLEY. Mr. Chairman, I guess the quandary which you face is how does the government measure unfair inaccessibility.

Our executives tell us that the most severe barrier is this cultural barrier, which is the quality problem.

The CHAIRMAN. Okay, so we can't handle that one. I don't see how you handle that one, except better quality of our products, and that is what in effect I think you are saying. I understand that. But that one aside, I can cite to you examples of foreign protectionism. All we have to do is read the National Trade Estimate and see pages and pages and pages of nontariff barriers that we are running into in other countries. And we are not free of that ourselves; we have a few ourselves.

I looked at a survey that showed there are 28 different ways governments could intervene in trade, that the Japanese exercised 25 of them, the Europeans 17 of them, and we exercise six of them.

Agreeing with your question of cultural barriers, the chauvinism, or whatever you want to call it, what about the others? How do you pressure them into opening up?

Mr. LILLEY. I think the terms that our CEO's used are that the government not pursue it in a high-risk low-reward fashion.

The CHAIRMAN. Come on, give me specifics. What do you mean by that? I don't want it high-risk, low-reward, either. I think everybody on this committee would agree with that. But if you have something that that is an unfair trade barrier, do you just accept it?

Mr. LILLEY. No. It is the question of the year. The American Business Conference has a number of companies that were almost seriously endangered by the negotiations with the Common Market that ended successfully. I talked to every one of those chief executives; they were very distressed that American corn farmers were being injured, unfairly; but they were equally distressed when their products, which were completely innocent victims—the successes they were having in Common Market countries, both importing and exporting goods—were going to be taken as hostage for a dispute that had nothing to do with corn.

The CHAIRMAN. Do you think that we would have had any reasonable settlement if we hadn't taken them on on that and run some risk?

You see, let me give you an example. When Greece came into the Common Market, we had some of the very same things happen then as we have now with Spain and Portugal going in, the loss of some $400 million of farm products being sold into Spain—not Portugal, just Spain. When that happened with Greece, we didn't do anything about it, we let it take place, and we lost some markets.

Then the European Community got into a mindset that, "We can do this without having to compensate. That is going to be the pattern."

I have a hunch that if we had had a standard of response and a continuity of response, we wouldn't be tried so many times. This time we took them on.

Mr. LILLEY. And we risked.

The CHAIRMAN. You bet, there is some risk. But if we hadn't done it, we would have lost that market with no compensation. And that, we thought, was a violation of the GATT. What do you do but accept some risk, in these things?

Mr. LILLEY. I think, knowing the companies that were involved in that issue, that they believed that the way the Administration was prosecuting the corn issue was about as tough as you could get, and to make things tougher would tend to make it more difficult for the other governments to yield without appearing—I mean, they have to stay in office, too—without appearing that they were being pushed around by the United States Government.

This was a very serious matter for about five or six of our companies.

The CHAIRMAN. Of course it is serious, it is serious for our country. But I think these are some of the risks we have to run in trying to get to the problems where we see a really, truly unfair trade practice. I wonder how your companies would have felt if it had been their product that had been denied entry? Reverse the roles.

Mr. LILLEY. I agree with you, Mr. Chairman. And they understand the corn farmers' situation and were very sympathetic. But they didn't know that they were going to be asked to volunteer.

The CHAIRMAN. All right.

Well, we obviously have some things going on over there on the floor; it looks like another vote. I see that next in the order of questioning, of those in attendance, is Senator Packwood. I will be back in a minute.

Senator PACKWOOD. Bill, let me follow up on what Senator Bentsen is saying.

If you are not going to have a game every now and then of chicken, with each of us having our wheel on the fenderline, we are going to lose every time. If we are going to have threatened retaliation in the hopes that they will back down because most nations want access to our markets, on occasion one of them isn't going to back down and you are going to have to retaliate to be credible, aren't you?

Mr. LILLEY. I am afraid so.

Senator PACKWOOD. Okay. And it cannot necessarily be sectoral retaliation. Korea won't let us sell any insurance of any consequence. We can't say to them, "Well, if you won't let us sell insurance, we won't let you sell insurance." They don't sell any insurance here, hardly a threat. Maybe if we say to them, "You can't sell hundaze here," that might make a bigger impression.

Mr. LILLEY. But I think, Senator, that we feel that, for a forced response to be mandated and made more inflexible and more threatening, it will make it more difficult for the other side, whoever the other side is, to step back when the cars approach each other, or to turn aside.

Senator PACKWOOD. Maybe. We have a whale of a market, though, that they want access to. And if we are threatening retaliation in things that mean big dollars to them, they will think twice before they will step back for something that probably means infinitely less dollars in terms of what we are asking them to give.

A question: What do you mean by "cultural barriers"? I wasn't quite sure, because you got into something about quality.

Mr. LILLEY. The American Business Conference companies believe that by far the biggest barrier to foreign penetration is the belief in the Common Market countries and Japan that American goods are of inferior quality to the domestically-made goods in those countries. That is by far what they regard as the biggest cultural barrier.

Senator PACKWOOD. And it has nothing to do with trade limitations or anything else, it is just that they think that their products are better. There is nothing we can legislate to overcome that, is there?

Mr. LILLEY. Certainly nothing that would have any impact in three or four or five years.

Senator PACKWOOD. And you don't come with a stone and say, "America is best here," and they all buy it. [Laughter.]

What do we do, then, with that? All you are saying is, "Give us access to the markets, and it is up to us to convince them to change their cultural identification."

Mr. LILLEY. Our executives said that they had to—and in some cases this was traumatic for them, because these are, as you know, blue-ribbon companies in this country and very successful, rapidly-growing, market-sharing United States companies—that for them to successfully penetrate the Japanese market, they had to improve the quality of their goods, and they thought they were already world-class quality.

Senator PACKWOOD. Wait a minute. In other words are you telling me that the Japanese cultural barrier is not just a perceived one but an actual one? That the goods are inferior?

Mr. LILLEY. For them to sell successfully, and this is particularly true for the high-tech companies—we have about 25 high-tech manufacturing companies where engineering standards are a major part of the consumer buy decision—they had to improve the quality of the product.

Senator PACKWOOD. So that is more than a cultural barrier but a product inferiority which you had to improve.

Mr. LILLEY. And in the case of the consumer goods, they had to market much more aggressively and innovatively their goods to convince the Japanese consumer that the product was of a high quality.

Senator PACKWOOD. And you are telling me that, for your companies, the bulk of the problem they face is that cultural barrier that has nothing to do with existing trade laws or access laws, or anything else in terms of at least access to the market?

Mr. LILLEY. That is correct. They do not deny, as Chairman Bentsen said, that there are governmentally-imposed barriers.

Senator PACKWOOD. But they are relatively slight in comparison to the cultural barrier?

Mr. LILLEY. The cultural barrier, the quality barrier bias, is the biggest. And that is why they make the point that they have had the success because the people who run those companies are either the product innovator or the marketing innovator, and that is because they are hands-on involved in the quality of the product and the quality of the marketing, not involved in the quarterly earnings that was talked about in another panel.

Senator PACKWOOD. Mr. Lilley, this is most significant testimony. You are the first witness we have had here who has put denial of access relatively lower on your scale of priorities, that you have higher problems than that which probably cannot be fixed by legislation. And you represent very hot companies, good companies.

You are saying to this committee, "You know, Japan is tough, but we can get in; Brazil is tough, but we can get in; the Common Market is tough, but we can get in. And if we get in with good enough quality products and good enough sales, either in consumer goods or wholesaling, we will do all right"?

Mr. LILLEY. Senator Packwood, I think from what I hear that Brazil might be a wild card. I think that some of their tariffs for some of the products are so high as to be absolutely prohibitive.

But the question of the quality/cultural bias was strongest in the EEC countries and in Japan.

Senator PACKWOOD. Well, it is most revealing, and I appreciate it.

Thank you very much, Mr. Chairman.

Senator BAUCUS. Thank you, Senator Packwood.

Why then, if you can basically compete with, I take it, very aggressive, imaginative, managerial will, why is it that some of the other American companies feel that we have to have some kind of a surcharge on, say, Japanese imports into the United States in order to "force them" to knock down some of these unfair trade practices? What explains the difference between your testimony and one of your predecessors who had spoken on a prior panel?

Mr. LILLEY. I must have been out when he mentioned the surcharge. But one of the points that we learned in the survey which was of interest, given the prevailing theories you hear about our lack of competitiveness is the high-wage problem, for our companies, that is not a problem.

Senator BAUCUS. Are your companies different than the larger, multinational companies? You represent mid-sized American companies.

Mr. LILLEY. Mid-sized, rapidly growing, but basically high-wage companies; there are only a few low-wage companies.

Senator BAUCUS. You represent high-wage companies?

Mr. LILLEY. Yes, sir.

Senator BAUCUS. And you are saying that the lower foreign wages is not an impediment to your companies?

Mr. LILLEY. In their total mix of costs, their labor and resource costs are fifth and sixth.

Senator BAUCUS. Does that mean that more of your companies are producing here for export rather than out-sourcing?

Mr. LILLEY. Of the 100 companies, about 47 have done some outside sourcing; but a large, very large, and in some cases 100 percent of the production is here for export.

Senator BAUCUS. Why, in your judgment, are ABC companies apparently doing fairly well under the current international arrangements, whereas companies like Motorola are having a harder time? What explains that difference? What is your gut guess?

Mr. LILLEY. Well, I think the answer implicitly was in the previous panel. ABC people are the product-innovator or the market-innovator that are running these companies. They often, along with their employees, own large chunks of the stock. They are not subject to the quarterly pressure of the financial community. They are much more involved, rather than smoothing rings or working with Wall Street—they are much more involved in the product innovation and the marketing innovation, and therefore they talk endlessly about the need for patience, for risk-taking, and all of them talk about the need to accept the fact that if you are going to penetrate a market, particularly a Pacific Basin market, that you have to be willing to accept losses.

Senator BAUCUS. Then you very much agree with those who are saying that part of the problem at home is the short attention span of America, particularly with the listed companies, that they ought to pay more attention to quarterly reports, short-term performance, et cetera, and that that is an impediment to American international competitiveness, and you think that is a very specific problem?

Mr. LILLEY. And they would agree with that, and they thank themselves that they perhaps are still young enough in their institutional age that they are largely owned by themselves and their employees, so that they are protected from this enormous pressure that the two gentlemen before were talking about that the institutions put on companies.

Senator BAUCUS. What are one or two recommendations you might have to help larger, multinational companies—listed companies, publicly-held companies—address the long term war? That is, what legislative actions might we enact here to help those larger companies, publicly-held companies, think in more long term? Does anything come to mind?

Mr. LILLEY. Has Senator Bentsen introduced a bill about pension-fund holding of stock?

Senator BAUCUS. I am working on that, as are others.

Mr. LILLEY. I think that, if we become much more oriented to solving this international competitiveness problem, something that could be done that would ease the pressure, that would allow people to take a longer-term framework, would be much better.

Senator BAUCUS. I am going to have to temporarily recess this hearing. I think that Senator Bradley, when he comes back after the vote, wants to ask further questions.

Mr. LILLEY. Thank you, Senator Baucus.

Senator BAUCUS. So, the hearing is temporarily recessed until the further call of whoever is going to come back and chair the rest of it.

[Whereupon, at 12:08 p.m., the hearing was recessed.]

O

71-855 (213)