
Global Competition—The New Reality

Results of the President's Commission

On Industrial Competitiveness

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Our ability to compete in world markets depends on decisions made by both public servants and private citizens in pursuit of four key goals: (1) to create, apply, and protect technology—our greatest competitiveness advantage; (2) to increase the supply of capital available for investment and reduce its cost to American business; (3) to develop a more skilled, flexible, and motivated work force; and (4) to make trade a national priority at home and to strengthen the world trading system in which we operate.

Those of you who were around some 25 years ago can remember what we felt at that very visible image of a Russian rocket blasting its way into space. That first sputnik wounded our pride, strengthened our resolve, and set off a national effort to be the first on the moon. And, of course, we were. What this country needs today is to have the Japanese launch a Toyota into space. Or perhaps a Sony Walkman.

The Competitive challenge we face today has consequences just as serious as a threat we felt a quarter of a century ago. This one is just subtler, and a whole lot quieter. Perhaps that is why this nation has not yet responded wholeheartedly or effectively to the challenge of competition from abroad. Emphasizing the urgency of competitive renewal in this country is not an easy task in the middle of the strongest economic expansion of recent history.

For the past 18 months I have been the chairman of the President's Commission on Industrial Competitiveness. The commission comprised leaders from industry and labor, from the high-tech and basic industry sectors, from large and small businesses, and from government and academia. Both Democrats and Republicans participated—even though in the middle of an election year.

Yet the final report that the commission submitted to the President¹ was unanimous in its key findings, which were these:

1. There is compelling evidence that this nation's ability to compete has declined over the past 20 years. We see its effects both in our domestic markets and in our ability to sell abroad.
2. We must be able to compete if we are going to meet our national goals of a rising standard of living and strong national security for our people.
3. Decision makers in both the public and private sectors must make improved competitiveness a priority on their agendas. As a nation, we can no longer afford to ignore the competitive consequences of our actions—or our inaction.

Before I go any farther in outlining the dimensions of our nation's competitiveness problem, let me try to explain its significance.

Competitiveness can be defined as the degree to which a nation can, under free and fair market conditions, produce goods and services that meet the test of international markets *while at the same time maintaining or expanding the real incomes of its citizens*. That definition was a matter of choice for this nation, and it demonstrates what is at stake in being competitive. As a nation, we are not going to lower our wages in order to compete. At least no one I have met has ever offered to cut his or her paycheck in honor of this worth cause.

The challenge, then, is to earn our wages in an interdependent and highly competitive global economy. One-fourth of the goods produced in the world cross national borders, and fully 70 percent of the goods produced here in the United States compete against products made abroad. These facts lead to this simple conclusion: the wages we get paid—the high standard of living we enjoy—must be earned in the world market. No one bestows them on us as a right. In a world in which only guest speakers receive a free meal, competitiveness is what pays for whatever we have placed on our personal and public menus.

INDICATORS OF DECLINING U.S. COMPETITIVE PERFORMANCE

¹ President's Commission on Industrial Competitiveness, *Global Competition: The New Reality*, John A. Young, chairman (Washington, D.C.: U.S. Government Printing Office, 1985).

No single indicator gives an adequate representation of our nation's competitive performance. The commission identified five trends, and they all point to a declining ability to compete. First, growth in American productivity has been surpassed by that of all our major trading partners. The Japanese productivity growth rate is five times greater than our own. In absolute terms, Japan is more productive than American industry in autos, steel, and electrical and precision machinery. It is no coincidence that these are the industries in which the United States has seen the greatest effects of foreign competition.

Second, real hourly wages in the business sector have remained virtually stagnant since 1973, and they have actually declined in the past five years. Recall that competitiveness was defined above as our ability to succeed in world markets *while maintaining our standard of living*. Our failure to earn increasing real incomes means we are not meeting that test.

Third, our manufacturing sector is not generating the kinds of real returns on assets that encourage investments. Twenty years ago the average real pretax return on manufacturing assets was almost 12 percent. In 1983, it averaged about 4 percent. Investors can do a lot better by putting their money in financial assets. The members of the commission were firm in their conviction that we cannot rationalize the poor performance of manufacturing by arguing that we are becoming a service economy, anyway. Our manufacturing sector is the *foundation* on which many services rest.

The fourth trend that concerned the commission is even more dramatic: U.S. trade deficits are at all-time highs—more than \$125 billion in 1984. For this entire century—until 1971—we ran a positive balance of trade. Since then there has been a steady—and alarming—trend to the negative. Much of our current deficit can be blamed on the strength of the dollar, but that does not explain it all. Our trade deficit started in the 1970s when most people thought the dollar was 20 to 30 percent undervalued.

The fifth and final warning signal I would cite hits close to home. Since 1965, 7 out of 10 U.S. high technology industries have lost world market share. In 1984 this country had a trade deficit in electronics. Our bilateral deficit with Japan in electronics was \$15 billion.

That is more than our bilateral deficit in autos. Silicon Valley is *not* so far removed from Detroit.

In assessing our ability to compete, we should not take comfort from the fact that our economy is outperforming the European economies. That is like congratulating ourselves for finishing a race second to last. Instead, we should look to Japan and its neighbors—the newly industrializing nations of the Pacific Rim. The United States now does more trade with the countries of this area than with all of Europe combined. And our new Pacific Rim competitors have set a challenging standard by which to judge our own performance.

What can we do to reverse the competitive erosion of the past two decades? It would be nice if we could say, “Do just this, and everything will improve.” But our ability to compete depends on many factors—all of which are interrelated.

FACTORS THAT AFFECT COMPETITION

The Commission grouped the factors that affect our ability to compete into four subject areas that served as the basis for its working committees: technology, capital, human resources, and international trade. Let me highlight the key findings and recommendations in each area.

Technology

Technology is our strongest advantage in world competition. Yet we do not capitalize on our preeminent position, and other countries are rapidly closing the gap. Our first cause for concern should be about the kinds of technologies we investigate. As a nation, we spend a smaller percentage of GNP on civilian R&D than either West Germany or Japan. In other words, we invest relatively less than our trading partners in those basic areas of inquiry that could lead to commercial competitive advantage. Roughly half of all the R&D performed in this country is funded by the federal government. But most of that spending is for defense and space research. And, in the commission’s view, any spillover of those R&D efforts to commercial applications is incidental at best. That is why the commission

called for the creation of a cabinet-level Department of Science and Technology. Federal R&D funding that is not earmarked for defense represents an annual investment by taxpayers of more than \$18 billion. But it is an investment from which we do not reap enough reward. Federal efforts are scattered throughout several organizations and some 700 federal laboratories. Several recent studies, David Packard's² among them, point to major administrative inefficiencies.

By one count, there are some 2,700 distinct federal R&D program elements that receive line-by-line budget scrutiny from 54 congressional committees and subcommittees. That is a managerial maze that few scientists are equipped to navigate.

As part of the effort to create technology, the commission called for permanent tax credits to stimulate more industry research and development. Tax credits are preferable to direct government project oversight, because they allow the market to determine which technologies have commercial potential.

Encouraging private sector research and development is an appropriate goal of government. Technological advances create a rippling of benefits throughout the economy. Those who pay for the research cannot capture all the benefits. Take the microprocessor as an example. It is now used in cars, microwave ovens, stereo equipment, medical diagnostics, and a whole range of other applications. It has provided a competitive advantage for many American industries that did not in any way contribute to its development.

Turning now from *creating* technology to *applying* it, perhaps this nation's most glaring weakness in technology is the failure to devote enough attention to manufacturing applications. It does little good to design state-of-the-art products if someone abroad can rapidly copy and produce them at a lower price. Robotics and statistical quality controls were both first developed here in the United States. But it was the Japanese who applied them—and brilliantly—to the manufacturing function.

² White House Science Council Federal Laboratory Review Panel, Report of the White House Science Council Federal Laboratory Review Panel, David Packard, chairman, May 1983, PB 83255620, Springfield, Va.: National Technical Information Service.

But manufacturing simply has not been stylish with us. Within industry, manufacturing managers have been paid less than people in marketing or in R&D. Within our universities, there has been little interest in process technologies and manufacturing management. You can count on one hand the number of universities doing research in this area.

Creating and then applying technology are just the first two steps in a competitive strategy. The results of innovation must also be protected from counterfeiting and other forms of misappropriation. In this regard, we need to review and reform our patent laws, better protect the scientific information that American business provides to government, and insist that our trading partners—especially the newly industrializing countries—provide better protection, too. According to the International Trade Commission, counterfeiting alone cost American business \$8 billion in sales and 131,000 jobs in 1984.

Capital Resources

Let us assume that, as a nation, we do a magnificent job in technology. We have a wealth of research that has commercial potential. We quickly and broadly apply technological innovation to create market advantages, and we protect our intellectual property. All these advantages could be to no effect if we have created for ourselves a major disadvantage in another area—capital resources. This is where economics and technology really merge.

If you rank our six major trading partners on capital formation, that listing will almost exactly mirror their trading partners on capital formation, that listing will almost exactly mirror their ranking in productivity growth. Moreover, Japan would be at the top of both rankings and the United States at the bottom.

The commission investigated the reasons for the low level of U.S. investment by asking for testimony from a wide range of economists. To our great surprise, they were in agreement. The consensus of their opinion was that high capital costs are a competitive disadvantage for American firms. In fact, compared with Japanese costs, American capital

costs are at least twice as high. This disparity in costs hurts the ability of U.S. firms to compete. In fact, studies have concluded that lower capital costs—not technological supremacy—were the prime factor behind the Japanese incursion into the U.S. semiconductor industry.

If we are going to reduce the cost of capital to American industry, however, we will have to deal with some major “macroeconomic” issues. First, we will have to cut the deficit. Government must reduce competition with industry for scarce capital resources. Federal borrowing pushes up interest rates and makes the dollar strong. Since 1980, the value of the dollar has almost doubled compared with the value of major European currencies. For companies trying to sell in international markets, that means higher prices for our exports and fewer sales abroad.

Second, our tax system must be restructured. It is currently a de facto industrial policy, and a poor one. It discourages savings and encourages borrowing. It also results in the highest effective tax rate for that sector of our economy most affected by international competition—manufacturing.

The commission did not evaluate the likely consequences of the many tax reform proposals currently under discussion, but it did propose several criteria that can be used to judge the consequences of each proposal for U.S. competitiveness. Among the criteria are the goals of more neutral tax treatment for different industries and kinds of assets and encouraging investment, such as by indexing inflation for calculations of capital gains and allowing fuller deductions for capital losses on individual income tax returns.

A third way to lower the cost of capital to American firms is to pursue a more stable monetary policy. The commission’s final report has a graph that plots the variation in the consumer price index and prime interest rates since 1971. It looks like a roller coaster, but one with jagged peaks. Unstable monetary policy adds to high capital costs, because it forces lenders to add risk premiums to their loans.

And to those who blame American business for its short-term investment perspectives, I say that there is a reasonable excuse. It is difficult to do long-term planning and

investment in a wildly changing business environment. Besides, no lender would put out a 20-year note anyway. High capital costs force a short-term outlook.

Human Resources

So far, I have talked about only two of the four areas the commission explored—technology and capital resources. But it is more complicated than that. Our ability to compete in world markets—and to maintain the technological preeminence that is our strongest advantage—also depends on other factors.

The most insightful business strategy in the world is doomed to failure if it lacks a dedicated team of players to carry it out. The commission's third area of inquiry was human resources, and the members concluded that the United States faces a number of unmet challenges in this area. First as Donald Kennedy (in this volume) explains so well, we must strengthen the capacity of our nation's research universities to explore promising areas of innovation and to train the scientists and engineers we need.

Second, we must create better ways of helping our mature work force adapt to change—whether that be retraining for displaced steelworkers or on-going education to keep electrical engineers abreast of developments in their field.

Third, both American management and labor need to recognize their shared stake in the competitive challenge and find ways of forming a consensus on goals within their business organizations. That is why the commission advocated broader use of such incentives as profit sharing and employee stock-purchase programs.

International Trade

The subject of international trade—both the way we approach it here in the United States and the global trading environment that American business operates in—raises tough issues.

The commission's first conclusion was that international trade has simply not been a national priority. Responsibility for trade policy is splintered. A diagram of who makes and implements policies affecting trade would have to include the two major actors—the Commerce Department on one side, and the U.S. trade representative on the other. Then there would have to be lines representing the various pieces of the action owned by the Departments of Defense, Treasury, Agriculture, State, and a host of other executive agencies and congressional committees.

The resulting picture of the process by which our trade policy is formulated would be more complicated than a design schematic for the most advanced integrated circuit. The complexity and lack of accountability make it impossible for us to deal with the growing importance, and the number, of issues we must resolve.

That is why the commission recommended the creation of a cabinet-level Department of Trade: to provide a single strong voice for trade issues. We have been told that we cannot expect such a major reorganization to happen in the near future, that it is not politically feasible. But we have some opportunities for greater focus with the formation of the new Cabinet Council on Economic Affairs headed by Treasury Secretary James Baker.

There are a number of other things we should do to get our own house in order when it comes to trade. First, we need a new omnibus trade bill that provides ways to help U.S. industry adjust to international competition before the damage is irreparable. Second, we must search for a more uniform approach to export controls. We often prohibit the export of technology that our allies consider allowable. The commission heard testimony that put the cost of our stricter rules at more than \$12 billion in lost U.S. sales each year. For technology that we do allow for export, we need to streamline the licensing process. It takes American exporters far longer to obtain licenses than their competitors abroad. Third we should be looking for ways to encourage U.S. exports. These include more competitive export financing, better information about foreign markets, and the active support of U.S. embassies abroad.

As it looked at the international trade environment in which American business operates, the commission saw two trends going on simultaneously—and pointing in opposite directions. On the one hand, the total volume of world trade has grown enormously—a sevenfold increase since 1970. On the other, the portion of that trade covered by agreed rules has shrunk dramatically. There is no coverage in those rules for trade in services or investments. There is little provision for agriculture or state-owned industries. And while tariffs have come down, the use of nontariff barriers has increased significantly.

Like American trade law, international rules have not yet responded to foreign governments' targeting policies and nontariff barriers. And the newly industrializing nations have only the weakest commitment to the rules, at best.

We must strengthen the international trading system by increasing the amount of trade and the kinds of practices it covers. And we should get our trading partners—especially the newly industrializing countries—to commit to its rules.

SUMMARY

I began by saying that our ability to compete in world markets depends on decisions made by both public servants and private citizens in four basic areas, and I have sketched some actions we can take to attain key goals in each of them. Those goals are as follows:

1. to create, apply, and protect technology—it is our greatest competitive advantage;
2. to increase the supply of capital available for investment and reduce its cost to American business;
3. to develop a more skilled, flexible, and motivated work force; and
4. to make trade a national priority at home and to strengthen the world trading system in which we operate.

Let me share with you my personal reactions to the response our final report has received so far. I am sometimes asked to choose *the* major recommendation that the commission made. This I refuse to do, because I do not want anyone to think that improving our competitiveness can be done with just one act. That would be like saying that a business can succeed by just managing its inventory better—while at the same time ignoring its R&D activity, accounts receivable, employee development, and the rest of its activities.

Some have expressed disappointment that the commission did not come up with “anything really new.” To those who attracted to “newness,” I say that there is simply no substitute for excellence in executing the basics.

The commission did not identify any new roles for government. Rather, what it tried to make clear is the fact that government has not yet effectively performed the legitimate roles it already has. Government is responsible for creating an environment within which American business can effectively compete. That basic goal has not been achieved.

The commission’s call for renewed attention to the fundamentals also applies to those of us in the private sector. The ultimate responsibility for being competitive rests with us. The foresight of our strategies, our responsiveness to customers, the cost and quality of our products, the commitment to developing our work force—these affect our performance far more than anything government can do for us. These challenges are not new, but we must address them with new vigor.

What do I think will be the result of the commission’s efforts? President Reagan and the Cabinet Council were very interested in the commission’s findings, and we have received many requests for copies from members of the administration and other Washington leaders.

It is still too early to judge the final effect of the commission’s efforts. History moves a bit more slowly than that. Of this I am certain, however: our nation’s policymakers are

beginning to pose the question that most needs to be asked: “How does that decision affect our ability to compete?”

What gives me even greater hope is the fact that American industry has not been waiting for a commission report. I see a renewed aspiration to excellence—an unleashing of competitive potential—in industries across the country. If it accomplishes just that—makes improved competitiveness *the standard* by which the public and private leaders weight the decisions they make daily—then the Commission on Industrial Competitiveness will have accomplished its goals.

All of us face a new reality—global competition. It requires from us a new vision and a new resolve. If we can forge these, we can—and will—meet the challenge we face.

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