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Washington University in St Louis

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Baseball is traditionally the national pastime, but in Washington in recent months, the most popular activity seems to be "Japan bashing." As the U.S. trade deficit heads for an all-time high, senators and representatives are tripping over themselves to blame the Japanese for this country's trade woes.

Nor is this scapegoating limited to the nation's capital. Some of my conversations with business and labor leaders whose companies are hard hit by imports remind me of the gripes of students who cut class, do not do the homework, and then complain when you give them a low grade. Unfortunately, the parallel is very appropriate; so much so, that our political and business leaders could benefit from the same type of response that I give those students—namely, a friendly "dutch uncle" talk.

The absenteeism rate in key U.S. industries hit by imports is several times that of Japan. Our labor turnover rate is much higher. Our quality is often poorer—for example, as measured by U.S. products' failure to meet minimum standards of production.

One large U.S. company that is losing its share of world markets still has to pay a bonus each time a worker puts in a full week. That is like my having to give an apple to each student who shows up for class on time. The sad truth is that many industries in the United States

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still match low productivity with rising labor costs. We cannot blame that problem on foreigners.

Erecting additional trade barriers is not the answer. I said additional because our hands are certainly not clean when it comes to open trade. We have erected our share of obstacles to imports. We may have convenient memories. But I speak from my own government experience when I assure you that foreign business executives can cite chapter and verse on U.S. trade restrictions.

Even if Japan did not trade with the United States at all, we would still be suffering record-setting trade deficits. . . We must be doing something basically wrong.

Despite the lip service that is so often paid to the virtues of free trade, there is great danger that the United States is taking the lead in the new rush toward protectionism. Public policy debates are now dominated by one-sided, self-serving views of international trade. Everyone wants open markets and free trade overseas. We all know how urgent it is to eliminate foreign barriers to our exports. But we rarely even acknowledge United States' barriers to foreign exports.

The tendency to focus on Japan as the source of our foreign trade problems is growing. It is true that Japan maintains an intricate variety of obstacles to imports that compete with its own products—and its government only reduces those obstacles in response to constant pressure from the U.S. Furthermore, our trade deficit with Japan—$33 billion last year—is far greater than that with any other country. In fact, trade with Japan accounted for nearly one-third of our entire merchandise deficit in 1984.

Yet we must face the fact that, even if Japan did not trade with the United States at all, we would still be suffering a painful and historically high excess of imports over exports. Without Japan, our total 1984 trade deficit would have been $69 billion—$11 billion more than the previous year's record-breaking performance.

Let me cite just a few other examples of our country's trade relationships. Our traditional export surplus with Western Europe has turned into a trade deficit ($13 billion in 1984). Our trade accounts with Canada and Mexico are also in the red—$20 billion and $6 billion respectively last year. In fact, the United States has a trade deficit with almost every nation in the non-Communist world and has had such deficits for some years.

Hence, it is silly to keep saying that everyone is out of step except us. We in the United States must be doing something basically wrong. If we are going to bring our imports and exports into balance, we need to reexamine our country's foreign trade and other economic policies, avoiding any preconceptions.

U.S. Barriers to Imports

It would help to clear the air if we would acknowledge that not all of our actions are on the side of the angels. We have created many obstacles to inhibit imports into the United States. Let us examine a few.

"Buy American" statutes give preference to domestic producers in federal, state, and local government procurement. By law, most purchases under the program of aid to mass transit must use American materials and products. Also, American flag vessels must be used to ship at least one-half of the gross tonnage of all commodities financed with U.S. foreign aid money.

The Federal Government's Jones Act is the opposite of keeping up with the Joneses. It prohibits foreign ships from engaging in commerce between American ports. This law effectively bars competition in U.S. domestic marine transport. The perverse effects of such laws are much greater than you might expect. Because domestic timber from Oregon that is sold in Southern California must be shipped in high-cost U.S. vessels, at times Canadian lumber transported by Japanese flag vessels has undersold domestic timber in that major west coast market. In such cases, both the American merchant marine and the American timber industry suffer damage. Foreigners then become the unintended beneficiaries of these backfiring attempts to subsidize the American merchant marine.

Various agricultural laws limit imports of products such as sugar, beef, dairy produce, and mandarin oranges. Other laws and international agreements limit the amount of steel and textiles that can come into our country. From time to time, we have imposed quotas on shoes and autos. The restriction on Japanese cars was informal, but no less binding.

We all know that our average tariff rates are low. Yes, they are almost as low as Japan's. Of course, we do levy high tariffs on some items. Tariffs on textiles average 20 percent. Duties on fruit juices are over 27 percent—even clothespins are hit with a 17 percent levy. As a matter of fact, the proportion of imports covered by tariffs is growing. In 1950, the United States allowed 54 percent of all imports to enter duty-free. Despite all of our talk about being the only country that practices free trade, by 1981 only 30 percent of our imports were allowed in without paying a tariff.

Moreover, numerous nontariff barriers, often of a regulatory nature, are imposed by federal, state, county, and municipal governments. Local building codes are a popular device to keep out foreign competitors.

U.S. Barriers to Exports

We must also acknowledge the great extent to which our government has erected obstacles to our own exports. These are self-inflicted wounds. It makes us a laughing stock overseas when we urge other countries to lower their barriers to our exports while we ourselves make it more difficult for our exporters. Approximately 10 percent of our exports is now subject to these types of barriers.

Numerous domestic statutes and regulations limit our exports. One law prohibits the export of oil from North Slope fields in Alaska. Another bans timber exports from federal lands west of the 100th meridian. When restrictions get that specific, you can detect the rich aroma of special interest pressures.

Export controls call into question the reliability of the United States as a supplier.

In addition, the Export Administration Act provides for controls on exports of goods and technology to protect national security. That sounds fine. But, in practice, the law mandates controls over a great variety of products, including unprocessed red cedar and—my favorite—horses exported by sea.

In 1980 the Export Administration Act was employed to embargo grain shipments to the Soviet Union. It was invoked again in 1981 and 1982 to carry out the ban against U.S. firms participating in the construction of the natural-gas pipeline between the U.S.S.R. and Western Europe.

Furthermore, export controls do more than limit U.S. international trade for the time they are imposed. These restrictions also call into question the reliability of the United States as a supplier of products to other countries, which therefore are likely to develop alternative sources.

A clear example is soybeans—hardly a strategic item. The purpose of the 1974 embargo of soybean exports was merely to contain a short term increase in domestic prices. However, the main effect of the embargo was to induce Japan to turn to other producing countries, particularly Brazil. Japan proceeded to invest in that country to develop alternatives to U.S. production, thus effectively and permanently reducing our share of the world soybean market.

The United States also conducts a great variety of domestic regulatory activities that impose costly burdens on American manufacturers. In many cases, foreign producers are not subject to similar burdens in their home country. For example, a comparison of U.S. environmental regulatory policy with that of the United Kingdom concluded that our government's approach has been relatively insensitive to the objectives and unresponsive to the objections of private enterprise, and that our regulatory regime is "more coercive than in any other industrial democracy."

In addition to the effects of trade policies themselves, the strong foreign exchange value of the dollar makes it extremely difficult for American companies to compete in world markets. Many factors influence the strength of a nation's currency. But our extraordinarily high real interest rates are very important. In turn, the large budget deficits are a key influence on those rates—and we cannot blame the deficits on "foreign devils." They have a made-in-America label.

By no means is the United States the only nation with trade barriers. Every nation has them and they continue to grow. However, the concerns of both our manufacturers and the consuming public will be far better served by responding to the underlying problems that generate pressures for protectionism. The answer surely is not to retaliate and thus open

the way for a return to the trade wars of the 1930s which exacerbated the Great Depression.

The Pressures for Protectionism

How should we respond to the foreign trade challenge? The first step is to understand why protectionism is popular. It is a means by which small, well-organized groups use the political process to their advantage. The benefits are received by the protected industries, while some costs are shifted to other companies who buy from the protected industries. Ultimately, most of the costs are borne by consumers in the form of higher prices. Thus, protectionism can be viewed as a hidden tax on the consumer. A study at our Center for the Study of American Business at Washington University estimated that hidden tax. In 1980, it came to more than $58 billion or $255 for each American consumer.

Like so many sales taxes, those born of protectionism are unfair. For example, "voluntary" quotas on imports of footwear served as a regressive tax whereby low-income consumers were harder hit than high-income consumers. The Reagan Administration eliminated these footwear quotas in 1981, but pressure now mounts to restore them.

It is fascinating to note that the consumer stake in free trade is as striking in Japan as in the United States. The following is a letter to the editor of the *Mainichi Daily News* written by a Tokyo housewife:

> Many of us city wives are now fed up with having to pay as much as 500 yen to 700 yen for 100 grams of beef because the government keeps restrictions on its import. Husbands are asked to buy beef for *omiyage* (souvenirs) at American or Australian airports on their way home to bring back to their families because beef is much cheaper in those countries. Oranges and grape-

fruit can also be much cheaper if only our government liberalizes its imports.

The government says it cannot lift the restrictions because the Japanese farmers should be protected. But the Japanese farmers are now the most privileged people. They are paying much less tax than salaried people in the cities. Some of them are even paid for not growing rice in their paddy fields. The farmers are much better off in politics because rural *senkyo-ku* (constituencies) elect more Diet members than city *senkyo-ku* per population. Sometimes a city Diet member represents four times as many electors as a rural MP.

I cannot but suspect that politicians and officials are not so patriotic as they claim, and they seek their own good by spoiling our farmers. Politicians can retain their seats in the parliament and get political funds from the farmers' organizations. Bureaucrats can keep key posts in corporations and other bodies which control the import regulations for their own post-retirement jobs. Why should we city people support these farmers (and politicans and bureaucrats) by paying much more for beef and oranges (and rice, too) than in other countries?

Protectionist measures are a two-edged sword. They may reduce imports from abroad, such as the "successful" effort by the United States in getting the Common Market to restrict its exports of steel to us. But our domestic automobile industry, a major purchaser of steel, bears the burden of higher costs, which in turn makes it less competitive. The net effect is added pressure for more protection.

We have another example in the textile sector. In 1983, domestic producers succeeded in getting the Federal Government to establish quotas on imports of textile products from China. By the way, the Chinese must have wondered about those "inscrutable" Occidentals, because we have enjoyed a large and rising trade surplus with them. How are they going to be able to continue being a major customer of American farm products if we do not buy their goods?

In any event, the Chinese reacted to our protectionist policy by reducing their imports of agricultural and chemical products from this

country. Once again, the benefits of protection were gained by one special sector of the economy and the burden was felt by innocent bystanders.

In the protectionist game, there are always winners and losers. . . The main losers are invariably the consumers in the country raising barriers to imports.

In the protectionist game, there are always winners and losers. Although the list of winners changes, the main losers are invariably the consumers in the country raising barriers to imports. Thus, it was the American consumer and not the Japanese producer who bore the costs of quotas on imports of Japanese automobiles in the early 1980s. As "visionary" economists warned "practical" businessmen, Japanese auto producers responded to the so-called voluntary agreement to limit their sales of motor vehicles in the United States by exporting their more expensive models and loading them with profitable extras. Japanese producers achieved record profits from their sales of automobiles in the United States during the period of the import restraint. While they exported about 30 percent of their auto production to this country, they earned approximately one-half of their profits from U.S. sales.

Moreover, the dealers for Toyota, Nissan, etc., benefited from the willingness of American buyers to pay substantially more than the sticker price (up to $2,000) in order to obtain the then relatively scarce Japanese product. The American auto buyers paid about $5 billion a year more for cars than would have been the case in the absence of the import restraints. When we stop to think about it, that is the result you would expect. Reducing the supply without changing demand results in higher prices. Unfortunately, $5 billion is a high price to pay for economic illiteracy on the part of government policymakers.

The Case for Free Trade

We must focus once again on economic fundamentals. In the immortal words of Adam Smith:

> It is the maxim of every prudent . . . family, never to attempt to make at home what it will cost . . . more to make than to buy. The tailor does not attempt to make his own shoes, but buys them of the shoemaker . . . What is prudence in the conduct of every private family can scarcely be folly in that of a great kingdom.

The arguments in favor of free trade and against protectionism are supported by a great deal of historical evidence. During the 1930s, the United States and many other countries followed "beggar-thy-neighbor" trade policies which contributed to the worldwide depression. The Smoot-Hawley protectionist tariff epitomized this approach in the United States. Unfortunately, memories are short. Some of our young people think that Smoot-Hawley is a British rock group.

Subsequent to the disastrous protectionism of the depression period, our trade policy shifted to the negotiation of reciprocal trade agreements. These tariff reductions were followed by an acceleration in world trade and economic growth. That was not just coincidence. The United States had similar experiences in the nineteenth century, as did other countries at other times.

Let us recapitulate the benefits of freer trade:

- Open trade contributes to lowering inflationary pressures by increasing the supply of goods and services competing for the consumer's dollar. Thus, the question of free trade is basically a consumer issue.
- Open trade minimizes the role of government in influencing private-sector decisions, thus allowing individuals and business firms to respond to the needs and pressures of the international marketplace. Free trade is key to promoting economic freedom and the private enterprise system.
- Open trade improves the efficiency with which our own resources are allocated. It thereby yields more growth, higher levels of employment, and an improved living standard here at home.

Positive Approaches to Foreign Trade Policy

Our large trade deficit did not develop overnight, and no panacea will cure the problem quickly. However, there are five sets of actions that will help to restore the competitiveness of American business, at home and abroad.

1. <u>Reduce the Budget Deficit</u>

There are two extreme positions on this issue, both of which I reject. One polar alternative blames the trade deficit entirely on the budget deficit, while the other absolves it completely. Although the linkages are complex and indirect, I do believe that financing a string of $200 billion deficits has pushed up real interest rates very substantially, and that has attracted large amounts of foreign capital to help finance the deficits. That substantial inflow of foreign money has increased the demand for dollars and, in turn, has resulted in a major appreciation of the dollar. The high relative value of the dollar has made it easier for foreign companies to compete against American companies, both in our home markets and overseas.

Moreover, reducing the budget deficit is inherently desirable for purely domestic reasons. The trend during the 1980s thus far has been for federal spending to be a rising share of the GNP. That trend should be reversed. I view deficit reduction as essentially a task of expenditure control rather than "revenue enhancement." Given the many low-yield programs that remain embedded in the federal budget, there is ample opportunity to make progress on reducing federal spending.

2. <u>Gear Tax Reform to Enhance Productivity and Competitiveness</u>

It is sad to note that most tax reform proposals to date ignore the repercussions on international trade. Many of the industries hardest hit by imports are precisely those whose tax burdens would rise the most under the modified flat tax proposals submitted both by members of Congress and the Administration.

Tax reform is inherently desirable, but it is not now the highest priority economic issue. This is simply not the time to elevate the development of an ideal tax system to the top of the roster of public issues. Rather, tax policy needs to continue emphasizing incentives for the items important to enhancing our international competitiveness—saving, investment, and research and development.

In pursuing the careful and time-consuming task of rewriting the Internal Revenue Code, we should learn from the experiences of the past. Narrowly-focused tax preferences geared to one industry or region are ineffective ways of using the tax structure. Such special-interest legislation should be avoided. The government is not good at picking "winners," particularly since the political power of old, declining sectors of the economy is usually greater than that of new, developing sectors of the economy. What is needed are broad-based incentives aimed at encouraging saving and investment generally.

3. Renew the Regulatory Reform Effort

The costs of producing goods and services in the United States can be reduced by launching another effort to reform government regulation of business. The elimination of some economic regulation has reduced the cost of transportation. This is not, however, a reason to dismantle social regulation. But closer attention to the tremendous costs imposed by EPA, OSHA, and other regulatory agencies would help to restore industrial competitiveness. All regulations should be subject to a tough benefit-cost test before they are issued.

4. Reduce U.S. Barriers to U.S. Exports

About one-half of our trade deficit with Japan could be reduced if Congress rescinded the bans on the exports of timber and oil.

Restraints on the export of strategic goods should be administered with common sense. It does not contribute to national security to prevent American companies from selling overseas items that are readily available from foreign competitors. We must supplement efforts to reduce our own trade barriers by continuing to pressure other nations to open their markets to our products and services. Japan is off to a late start in this regard, but its government now seems to be making a genuine effort to reduce trade barriers.

5. American Business and Labor Must Face the Challenge of Increasing Productivity

We cannot blame our poor production practices on foreigners. The answer is not to prop up industries with import restrictions or government subsidies—or to play King Canute and try to prevent businesses by law from closing down or "running away." Rather, labor and management in each company need to face the challenge of enhancing their competitiveness.

Management must show the way. Cutting back on the proliferation of staff activities and layers of executives creates an operating environment in which labor is more likely to accept changes in needlessly costly factory work rules. Protectionism is counterproductive since it lessens the pressure on management and labor to make the painful but necessary changes that enhance productivity. We all must acknowledge the painful fact that foreign competition is the most effective spur to greater productivity.

On occasion, albeit reluctantly, the necessary changes are being made. In both Weirton, West Virginia, and Johnstown, Pennsylvania, unprofitable steel plants were sold to the employees. What were the results? Faced with economic disaster and unemployment, tough decisions were finally made.

Wages and benefits—which were approximately 90 percent above the average for factory workers—were brought closer to competitive reality. Layers of management were eliminated.

Work rules were streamlined. Both plants are now operating in the black, despite the strong dollar and powerful foreign competition. Ironically, if the mutual suspicion of labor and management had been eliminated earlier, the changes needed to restore competitiveness could have been made under the original ownership and with much less disruption.

None of these five points is easy to carry out. But each represents a constructive response to our trade problems, and a far more economically sound approach than a burst of protectionism.

The pressures for "protecting" American products against foreign competition are rising. We as a nation can throw in the towel and erect more barriers to imports. But we know that doing so will not increase the competitiveness of our companies, that the consumer will wind up paying the bill, and that innocent industries will be hit by the inevitable retaliation of our trading partners.

Nor, I must admit, is the answer merely another sermon on the virtues of free trade. After all, a competitive world is a tough environment for business to operate in. But the more productive that our businesses become—and the lower their costs—the more competitive they will be. Thus, the future of American industry depends on decision-makers, in both the public and private sectors, supporting at least some version of the five-point program presented here. The longer they wait, the more American companies will have to play catch-up ball.

Fundamentally, the future of American industry will not be settled by government directives from Tokyo or Washington—but by decisions made in business offices and on production floors in Boston, Detroit, Chicago, Pittsburgh, Los Angeles, St. Louis, and other major cities throughout the nation.