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I want to spend some time with you this morning discussing the state of industry in the United States and its future in a more competitive world. I would suggest, like Kevin Phillips, that while "industrial policy" in the sense of picking winners and losers appears to have met a well-deserved fate, we will not retain our position of world economic and political leadership unless we can agree on and implement a strategy for industrial survival.

Deindustrialization is a popular topic at conferences in Washington these days. Economists, columnists, political scientists and other assorted pundits have produced reams of paper studying this question. Even though America may be deindustrializing at a rapid pace, I can tell you there is one real growth area -- and that is for economists.

By now, however, our trade and investment problems have been so serious for so long, that even economists can no longer deny their existence, even as they continue to preach an ivory tower version of free trade.

Indeed, there is no better place to look for proof than the report of the President's Commission on Industrial Competitiveness which came out in January. Among other things, that document reports:

- Beyond our $123 billion trade deficit, we are losing market share in industry after industry, and not just in "old" industries like steel and textiles. In high technology, for example, we have lost world market share in 7 out of 10 categories.

In part this is due to market restrictions elsewhere. In part we have inadvertently brought this on ourselves. For example:

- Although we spend huge sums each year on research and development, spending on <u>civilian</u> R&D -- that is, non-space and non-defense -- is less than in Japan and Germany as a percent of

GNP.

- Japan, with half our population, is graduating more engineers. They have the added advantage of graduating 1/20 as many lawyers.

- American fixed investment as a percent of GNP lags behind Japan, France, Italy, Germany, and Canada, as does our labor productivity. As the President's Commission reports, "Nations that invest more also have greater productivity growth. The United States ranks poorly in both of these areas when compared to our major trading partners."

- Over the past twenty years, real rates of return on manufacturing assets have declined. In the past four years they have fallen below the rates for alternative investments. We are sending investors a clear signal about where they should put their money, and it is not into our industrial base.

- And we are raising the cost of that money. Our savings rate lags well behind our developed trading partners, while our cost of capital is much higher, twice as high as Japan's.

- These developments are reflected in employment trends as well. Although we have created six million jobs during the current recovery -- a remarkable achievement -- they are primarily in services. Total manufacturing employment is still lower than in 1981. And in 41 states it is below the level of 1971. Total employment is still below 1979 levels in 17 states.

- Finally, the overwhelming impact of exchange rates has influenced all these developments. The dollar has appreciated over 40% in value in the Reagan Administration. As the dollar has gone up, our trade and current account deficits have soared with them. Larry Fox of the NAM staff has dramatically illustrated this change with several charts. And companies have responded accordingly. Caterpillar, for example, is closing down two of its modern facilities here in favor of new production in Korea, Scotland and Belgium. That kind of action is not only threatening to our national and defense manufacturing capability, it is also nearly irreversible.

These details document what you in this room already know and what the President's Commission has publicly reported:

"Our ability to compete in world markets is eroding . . . U.S. leadership in world trade is declining . . . The U.S. position as a world leader . . . depend(s) on the ability of American industry to compete both at home and abroad."

Those of you who know President Reagan will understand this is the last result he wants or seeks. But the report's message is clear: "Wake up, Mr. President, before it's too late!"

How did we get here? To begin with, this problem certainly did not start with Ronald Reagan. We have reached this point through a combination of missed opportunities in trade policy and misunderstandings in tax and investment policy that reach back well over a decade.

In part, the international trading system has been changing faster than we can adapt to it - or even understand it.

-- the integration of many national markets into a true world market.

-- the new importance of that market as domestic growth slows.

-- the failure of adjustment policies.

-- the growth in importance of non-Western trade players with different standards and rules.

These changes and others mean that our underlying policy premise in the post-war era -- unilateral free trade -- is no longer relevant. It may be ideal, but we are not living in an ideal world. And in a second-best world, you don't insist on first-best policies. Or, as my colleague Jack Danforth has said, when you have a $123 billion trade deficit, maybe it's time to cheat a little.

Unfortunately, this is not the first time the Administration has been asleep at the switch. We have for 4 years pursued a policy of benign neglect of international trade and financial systems. Even more, we have been proud of our ignorance.

- the dollar's appreciation, out of control and out of proportion has become a sign of strength.
- non-tariff barriers imposed by others against us are really signs we're not trying hard enough to sell our goods.
- the failure of our manufacturing sector to share in the economic recovery is a sign we are becoming a more sophisticated economy.
- when shoe workers in Maine are unemployed, that is, apparently, in the words of one ITC Commissioner, their own fault for not moving.
- trade deficits, like the budget deficits of only two years ago, apparently do not matter. Although I'm still waiting for the supply siders to tell us how we can grow our way out of them.

This approach to the global economy is like Alice in Wonderland and the effect of our non-policy is the same as telling American industry "off with your head."

There have been some recent signs the Administration is waking up. Most of them have come from the Treasury Department, notably our agreement to discuss international monetary issues and coordinated economic policy with our allies and trading partners. And there are encouraging signs in the leaked revisions in the Administration's tax reform proposal.

Congress is waking up too, but slowly. The Finance Committee -- alarmed by the strong dollar -- recently held hearings that clearly made the case for better coordination of fiscal and monetary policy among the major trading countries, including agreement on coordinated intervention in the exchange markets as a part of that larger policy and as a means of bringing the dollar down.

Further good news is the Senate action of passing a budget cutting spending by $300 billion over the next threee years. Tough, even bitter, medicine, but essential to our economic

survival.

Congress also established the case last year in the Trade and Tariff Act of 1984 for a more aggressive attack on non-tariff barriers. We have given the President the tools he needs for that purpose. His continued failure to use them -- like in the Houdaille case and the Administration's failure to develop a coherent policy for dealing with Japan -- will only force Congress to do his work for him.

Unfortunately, Congressional tools are considerably blunter. They include sledgehammers like an import surcharge and outright retaliation like John Chafee's bill to prohibit Japanese telecommunications importers.

In the case of Japan, my own view is that such a hard line approach is both necessary and inevitable.

From a narrow point of view, the Japanese system has been extraordinarily successful. Through adroit management of their currency and capital market, through careful government guidance and the close cooperation of groups in their society that in our country are dedicated adversaries, the Japanese have created a dynamic growing economy well-positioned to take advantage of technological change.

But there is a cost to such an industrial poilcy that we cannot ignore, because it is we and others outside Japan who pay it.

In some sectors products that can compete are simply excluded -- blatantly as in agriculture, subtly as in many industrial products.

In other sectors foreign competition is excluded only until the Japanese have an equal, or superior, product. Then, when it doesn't matter anymore, the door is opened. The result is market distortion...perhaps more clever, certainly more successful, but the person with the better idea -- with the competitive edge -- is out in the cold, unless, of course, he's Japanese.

One nation practicing this system is a problem. If every nation practiced it, commerce would be paralyzed completely. Yet the trend, at least in Asia, is to copy the system, given its obvious success.

The issue here, of course, is not simply erasure of our trade deficit with Japan. The most optimistic estimates suggest that completely open markets would only eliminate about half of it, and beyond that I have no intention of trying to repeal the law of comparative advantage. What the Japanese must understand, however, is that their policies, no matter how good they are for Japan, have consequences for us as well. And we must act in our interests, not theirs. That is not protectionism. That is not racism. That is not starting a trade war.

Indeed, the trade war has already begun. Japan started it over 20 years ago, but all the casualties are on this side of the Pacific.

Right now we are locked into an increasingly destructive cycle with Japan in which we complain, they produce a reform program -- six since 1981 -- we wait a few months and then discover it's meaningless, and complain again. They are unable or unwilling to take our problem seriously. We are unable or

unwilling to persuade them to do so. We are presently in the waiting phase following the sixth reform package. As before, I doubt we will see meaningful reform.

That is why I have introduced legislation calling for a twenty percent surcharge for three years on all Japanese imports. A surcharge has been criticized as being disruptive. To my mind, that is the strongest point in its favor. We have to disrupt the current relationship if we are to build a healthier one. And that means creating in Japan the political will -- based on necessity --to act and to change.

Japan, however, cannot be the sole focus of our international attention.

We need new approaches to opening up the trading system -- by encouraging our exporters and improving their market access.

We need to continue our efforts to remove our own barriers. Most critical there is our defense of the beleaguered Export-Import Bank. To destroy the Bank, as Dave Stockman has proposed, and as the Senate has agreed, in the face of a high dollar and increased foreign competition is to tell our most sophisticated industries they have no role on the international stage. Aircraft, power generation - conventional and nuclear - and other major sectors affecting thousands of prime and sub-contractors are being told there is no alternative to surrender in the export credit war.

And we should continue our efforts internationally to defend the market system by fighting dumping, subsidies, and non-tariff unfair trade practices that distort comparative advantage.

I will shortly be introducing comprehensive trade policy and reform legislation supported by the Labor-Industry Coalition for International Trade (LICIT) and the Trade Reform Action Coalition (TRAC). I urge you to review the provisions of these bills as they truly embody a trade policy for the 1980s and 1990s.

As I indicated earlier, deindustrialization is not just a problem of trade policy. It is also a result of a budget policy that emphasizes consumption without the willingness to finance it or curtail it. We are mortgaging our future economic growth, and foreclosure on industdrial America is in process. And beyond the budget, another piece of the puzzle is the failure of the Administration to sustain the pro-investment philosophy that was the hallmark of its first tax bill.

The Administration apparently still clings to the belief that we can grow our way out of our deficits, and that continued rate reduction will be the engine for that growth. Now I'm all for simplification and fairness.

But the overall effect of the original Treasury proposal is to discourage investment and savings in favor of consumption, largely through repeal of ACRS and the Investment Tax Credit. The only way such an approach can promote growth is by stimulating still more consumption at the expense of savings, and by shifting aggregate investment into industries that are less capital intensive. In other words, investment will move to sectors where there are more jobs per dollar of investment -- which means still more service jobs and fewer in manufacturing. We should be reforming our tax code, but it should include more

emphasis on savings and less for consumption rather than the other way around. The original Treasury proposal is essentially a blueprint for the deindustrialization of America through the creation of a service based economy.

By definition that will mean increased reliance on imports of manufactured goods as well as the dislocation of thousands of Americans in manufacturing jobs. Such a vulnerable position is totally inconsistent for a nation that claims the right to world economic and political leadership.

The irony, of course, is that this is industrial policy of the worst sort. It does pick winners and losers - and condemns an entire sector of our economy to the slag heap in the process. That the Administration apparently would do it accidentally rather than deliberately is cold comfort.

What happens here if ITC and ACRS are eliminated? We would have higher taxes on manufacturing and much lower taxes on sales. We would provide incentives for U.S. firms to locate new facilities or expand existing ones abroad to manufacture goods for sale back into the U.S. Because of the relatively more favorable cost recovery allowances that are available in other countries, such as Canada, U.S. firms would manufacture abroad where they would pay less tax on their "manufacturing" profit, and sell back into the U.S. at a reduced 33% tax rate on their "sales" profit.

Removal of these two foundation stones to capital recovery would act as a strong incentive to American businesses to increase investment overseas at a time when they are already under intense competitive pressure to do so from the high value of the dollar. It is clearly a result that we cannot accept. That is why I have urged Treasury Secretary Baker to revise his department's proposal. We will have a clear answer in the next few days.

In addition, there are some lessons Congress can learn from the tax policies of our foreign competitors. The Business Transfer Tax proposal takes a page from our competitors' book by imposing a tax on both imports and U.S. companies. It also learns from the Al Ullman memorial value added tax proposal. The BTT basically eliminates payroll taxes by allowing U.S. companies an offset of their tax against their FICA payments. This proposal should be given serious consideration. It aims at taxing consumption, not savings or investment and with modifications it could provide some of the protection that U.S. companies need.

What I am saying is that tax reform should not be just about lowering rates and eliminating preferences. It should be an opportunity to find a way to better implement our investment and trade policy goals. The two are linked, and it is time for both the White House and Congress to recognize that reality.

To sum up in brief, it is clear that the continued pursuit of trade policies that ignore others' barriers and the tax and exchange rate policies that ignore the investment needs of our manufacturing sector can only contribute to our further deindustrialization and sustained movement toward a service based economy. If we give away our industrial base through benign

neglect on the international front and passive budget and tax policy here at home, we will never get it back. And with it will go our position of world leadership - first economically and then just as certainly, politically.

Our situation reminds me of the priest and the rabbi who go to a prize fight together. As the boxers are about to go to the middle of the ring, the rabbi notices one of the boxers crossing himself. Puzzled, he turns to the priest and says, "Father, what does that mean?" "Rabbi," said the Priest "it doesn't mean a thing if you can't fight."

This morning I invite all of you to join with me in learning both how to fight and to know that fighting is essential - not just to win, but to survive.